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Insider Trading Framework in United States and Egyptian Stock Markets

Elsayed Eldaydamony

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INSIDER TRADING FRAMEWORK IN UNITED STATES AND EGYPTIAN STOCK MARKETS

Elsayed Eldaydamony*

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ABSTRACT

This thesis examines the law of insider trading in both the American and Egyptian legal systems. It seeks to pinpoint the policy rationale behind prohibiting insider trading, the theories of civil enforcement and criminalization, and the concept of tipping in the United States. It also analyzes the express statutory prohibition under Egyptian law. Furthermore, it explains the doctrinal link between securities fraud and insider trading in the U.S. as well as the enforcement mechanisms in place at the SEC, the NYSE, and the NASDAQ. It also surveys the surveillance authority of the Egyptian Financial Regularity Authority and of the Egyptian Stock Exchange. It concludes to that both the American and Egyptian law prohibit the offense of insider trading and that there is an effective enforcement mechanism in the United States. Yet, the Egyptian enforcement authorities still need to adopt a clear and more efficient

procedure for enforcing the offense of insider trading. The Egyptian Financial Regularity Authority resources should be bolstered to recruit skilled personnel and equip them with artificial intelligence technology.

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I. INTRODUCTION

The Egyptian Stock Market is one of the earliest stock markets in history. The first stock exchange established in Egypt was the Alexandria Stock Exchange in 1888. It was one of the five most active stock markets in the world. Unfortunately, due to the adoption of communist ideas after the 1953 revolution, market activities in Egypt radically diminished until 1992, when the Egyptian Government switched and started applying pure capitalist principles.¹ Since then, the Egyptian Stock Market began to grow. Egyptian Business Law Regulations adopted open market principles and strove to attract foreign investment. They incorporated global trade customs and gave as many incentives as they could, such as tax exemptions, simplifying foreign corporations' registration, and free capital rehabilitation.

However, the Egyptian Stock Market has not completely recovered from Egypt's communistic rule. The practices of investment in corporate stock have never been as strong as they are in the United States. Americans tend to invest heavily in the stock market, making it the backbone of the American commercial system.² More than half of the American population owns stocks and actively trades in the stock market.³ On the other hand, a middle-class Egyptian citizen rarely invests in the stock market on publicly held corporations.⁴ It seems this is mainly because of the limited number of listed companies in the Egyptian Stock Exchange, and not because of the lack of profitability of the investment.⁵

* Masters of Law Thesis, 2018 at Maurer Law School, University of Indiana

¹ Shahira F. Abdel Shahid, *Does Ownership Structure Affect Firm Value? Evidence from the Egyptian Stock Market*, SOC. SCI. RES. NETWORK (Jan. 2003), (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=378580.

² See *Illegal insider trading: how widespread is the problem and is there adequate criminal enforcement?*, Hearing Before the Comm. on the Judiciary, 109th Cong., 31-445 (2006).

³ Justin McCarthy, *Just Over Half of Americans Own Stocks, Matching Record Low*, GALLUP (Apr. 20, 2016), <https://news.gallup.com/poll/190883/half-americans-own-stocks-matching-record-low.aspx>.

⁴ Cf. Brooke Cobb, *Investment Options In Egypt*, INT'L STRATEGIES, <https://www.escapeartist.com/egypt/invest/investment-options-egypt/> (last visited Mar. 25, 2020). Egyptians usually invest in unreal economies, like the real estate market, and the resulting lack of stock investment practices between Egyptians have had a tremendous drawback not just economically but also environmentally because people usually direct their investment to real estate market and buy fertilized land and engage in soil dredging to construct houses and sell the units for profit or just keep it and gamble for expected future high prices. *Id.*

⁵ Justin Kuepper, *A Guide to Investing in Egypt*, BALANCE, <https://www.thebalance.com/a-guide-to-investing-in-egypt-1979021> (last updated Jan. 26, 2020).

The price–earnings ratio in the Egyptian stock market is higher than the American ratio.⁶ Partnership corporations and family-owned businesses are the most dominant forms of investment in the Egyptian commercial system. A culture of investing in the stock market is crucial for a healthy financial system. In order to recover the Egyptian financial system, the capital market regulatory authority must seek means to increase the number of companies listed in stock exchanges and develop a mechanism to raise public interest in investing in publicly traded companies.

In addition, market integrity is crucial for the robustness of active stock markets in any given country. The investor needs a fair market and trustworthy insiders. Market integrity is built on two main components: adequate disclosure and a fraud-free market. Stock market actors, such as directors, officers, key employees (insiders), broker-dealers, investment banks, and outside counsel (temporary insiders), play a crucial role in building market integrity. They have access to material, nonpublic information about the company. If these actors trade or tip someone else to trade based on this information, they can gain profits or avoid losses in a way that is not available to ordinary shareholders. Misusing this nonpublic information negates market integrity, and, for that reason, countries prohibit the offense of insider trading.

As in American securities regulations, Egyptian securities regulations that prohibit securities fraud are very broad. Egyptian law directly prohibits insider trading, but not on the basis of common law fraud as in American law. Egyptian securities regulations adopted different tools to curtail insider trading. Some of these rules expressly prohibit trading on the basis of material, nonpublic information, and others prohibit any fraudulent or manipulative acts that could influence securities prices. Criminalization of insider trading under Egyptian law finds its basis in the Capital Market Law (CML) No. 95 of 1992, which stipulates the penalty of imprisonment for a term not less than two years and a fine of up to 20 million EGP or twice the amount of gains realized, or the loss avoided.⁷ There are also different authorities who are empowered to enforce securities regulations. The Financial Regulatory Authority (FRA) is the main surveillance authority over the stock market. The CML empowers the chairman of the FRA with the right to prosecute any violation of its regulations and the right to settle in any stage of a lawsuit. Article 21 of the CML gives the stock exchange chairman the power to revoke transactions that in violation

⁶ *Egypt P/E Ratio*, CEIC, <https://www.ceicdata.com/en/indicator/egypt/pe-ratio> (last visited Dec. 24, 2018, 11:31 AM) (listing the price/earnings ratio in Egypt); *United States Steel PE Ratio*, https://ycharts.com/companies/X/pe_ratio (last visited Dec. 24, 2018, 11:33 AM) (listing price/earnings ratio in the United States). The total number of listed companies in Egyptian Exchange including Nilex are around 300. *Egyptian Exchange (EGX) - Listed Companies*, AFR. MKTS., <https://www.african-markets.com/en/stock-markets/egx/listed-companies> (last visited Dec. 24, 2018, 11:29 AM).

⁷ *Capital Market Law No. 95 of 1992* (Mar. 14, 2018) https://www.imolin.org/doc/amlid/Egypt/Egypt_Capital_Market_Law_1992.pdf.

of the CML or other related securities provisions.⁸ The Egyptian legal system also allows shareholders to bring private actions through a direct complaint to the Attorney General's office, which has the authority to prosecute insider trading after the permission of the FRA chairman.

This research intends to examine whether the Egyptian regulations that prohibit insider trading are sufficient and if there is an adequate enforcement mechanism in place. It will address the Egyptian regulations' shortcomings and steps to develop a robust framework where necessary. The study will compare and contrast U.S. and Egyptian securities regulations to examine if there are deficiencies in Egyptian securities regulations or its enforcement mechanism to prevent and prohibit insider trading. In the introduction, we define insider trading and the policy rationale behind the prohibition. Chapter I will be assigned to give a description of insider trading under American law in order to provide a reasonable background for the new reader. Chapter II discusses the enforcement mechanism in both the Egyptian and American legal systems.

A. Definition of Insider Trading

The term "insider trading" is a misnomer because insider trading applies to trade by persons who are not necessarily insiders of the corporation issuer. Insider trading can also be committed by "outsiders" who do not temporarily or permanently work or provide any services to the issuer.⁹ Also, the information that may form the basis for sale or purchase could be outside information, as in the case of tender offers.¹⁰ Further, insider trading may occur, theoretically, by canceling a contemplated trade based on inside information.¹¹ However, Rule 10b-5's "in connection with" element would

⁸ *Id.* The chairman of stock exchange may suspend trading offers and bids aiming price manipulation. He may revoke transactions which violate laws, provisions, regulations and decrees related to their implementation, or which have been carried out with manipulated prices. He may also suspend the trading of a given security in case its continuing transaction causes harm to the market or to participants in the market. The Chairman of the Authority may take any of the preceding actions at due time. *Id.*

⁹ *United States v. O'Hagan*, 521 U.S. 642 (1997). Outsider trading refers to securities transactions based on material nonpublic information by individual who are not insider nor temporary insider of the issuer, the liability in these circumstances was not available before indorsing misappropriation theory of insider trading. *Id.*

¹⁰ *Report of the Task Force on Regulation of Insider Trading - Part I: Regulation under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223,224 (1985).

¹¹ Definition of Insider Trading: Hearing Before the Subcomm. on Sec. of the Comm. on Banking, Housing, and Urban Affairs, 100th Cong. 75-705 (1987). I agree with Senator Armstrong when he questioned Mr. Cox saying:

"Can you violate insider trading law by not trading? In other words, suppose you are

not extend to decisions to forego a planned security purchase or sale. Federal Securities Laws do not define insider trading, and the term “insider trading” does not expressly exist in any legislation.¹² There was always reluctance when it came to codify a statutory definition for insider trading. Some scholars believe this reluctance was due to political reasons.¹³

Arnold Jacobs testified in his statement to the U.S. House Report, Energy and Commerce Committee saying that, in order to enforce the broad anti-fraud provisions, a statutory definition was not desirable and, if we did create a definition, “unscrupulous traders would skirt around any definition constructed.”¹⁴ The Securities and Exchange Commission (SEC) defended its

intending to trade and then come into possession of such information and then don't trade. Does that violate the law? He said no! But I don't agree because avoiding the loss if he will buy over valued stocks or gain profits by maintain stocks he was going to sell for undervalued price that's advantage not available for other shareholders

Id. at 126. However, because the Rule 10b-5 stipulated that the actionable insider trading act need to occur “in connection with” securities transaction not just by canceling a contemplated transaction, as professor Manne believe “[a] failure to sell cannot be violated of SEC Rule 10b-5, because there has been no securities transaction.”). Henry C. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 938 (1985).

¹² JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATIONS: SELECTED STATUTES, RULES, AND FORMS 486* (2017). The preliminary note to §240.10b5-2 says “This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory of insider trading under Section 10(b) of the Act and Rule 10b-5. The law of insider trading is otherwise defined by judicial opinions.” *Id.*

¹³ See Jonathan R. Macey, *From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading*, 39 ALA. L. REV. 355 (1988). Macey argues that there is one core side of the offense of insider trading is the political component, this side did not receive adequate treatment from securities scholars in compare with other cores like ethical and economic perspective. This lack of scholarly writing addressing the political perspectives of insider trading seems to be unbeknown in light of the current political fight among the SEC, Congress, and federal courts about who deserves to regulate insider trading. Each party had his own interests to be the regulator, and this could be clear if we reviewed their proposed regulations. The fact that federal courts are the least of three battled parties could be politically influenced make them able to articulate a reasonable treatment to insider trading. But this created a detest for SEC and Congress because of the original legislation authority they empowered in terms of securities regulations, and that leads to an intentional frustrate for the principle that the United States Supreme court had established treating insider trading over the years. *Id.*

¹⁴ The Insider Trading Sanctions Act of 1984: Hearing on H.R. 559 Before the S. Comm. on Banking, Housing and Urban Affairs, 98th Cong. 34-541 (1983).

“I know it when I see it, but I can’t tell you what it is”¹⁵ standard by saying, “the commission does not believe a statutory definition is necessary for the continued success of its enforcement program.”¹⁶ The SEC believes that adopting a certain definition may impede its enforcement actions and prevent it from dealing with new market trends. Furthermore, the SEC contends that the adoption of a definition will not increase the sanctions that are allowed under securities anti-fraud provisions. These views are backed up by the American Law Institute and the American Bar Association, who contend that this issue should be left up to further judicial development and that it is hard to come up with an exclusive definition that can encompass Rule 10b–5 as it evolves. Then, if we do not have a definition for insider trading, how may we describe a certain action as being insider trading?

Steinberg and Wang defined insider trading as “trading by anyone (inside or outside of the issuer) on any type of material nonpublic information about the issuer or about the market for the security.”¹⁷ Hence, insider trading is a generic term that applies to anyone, whether it is an individual or an entity, who lawfully or unlawfully obtains advantageous information—driven from inside the issuer or from the market about the issuer securities—and trades based on this information. Whether or not this trade constitutes trading “on the basis of material nonpublic information” will be determined under Securities Exchange Act of 1934 Section 10(b) and SEC Rule 10b-5, thereunder. However, Section 10(b) and Rule 10b-5 do not address all frauds that may be committed in the business, but only those “in connection with the purchase or sale of any security.” In other words, the fraud must somehow “touch” upon securities transactions.¹⁸

B. Whether or not Insider Trading Prohibition is Justified.

Some securities scholars, as well as economists, argued that trading on nonpublic information may benefit stock market efficiency. We will survey the core views for those who believe that insider trading should be legalized and follow that with counterarguments that refute that assumption.

1. Insider trading should be legal:

The stock market dynamic, which may occur due to insiders’ transactions, led some economists to concentrate their views on short-term economic benefits rather than the principles of fairness. They stand for the legalization of insider trading, alleging that it is a reward for performance and creates a new entrepreneurial role in the market.

¹⁵ *Id.*

¹⁶ Define Insider Trading, *supra* note 11.

¹⁷ William Wang & Marc Steinberg, INSIDER TRADING 1 (2010).

¹⁸ *Id.* at 200.

1.1 *Insider trading is a reward for performance:*

Henry Manne believes that the attack on insider trading is, in fact, a war against free capital markets.¹⁹ He compares the insiders' right to trade on their ideas and innovations with the patent system, which secures an exclusive right for the inventor.²⁰ He says insider trading promotes innovation.²¹ Each smart employee is an entrepreneur, and his valuable ideas are his capital and should be put into practice to profit.²² As capital increases its rate of return, ideas should be compensated.²³ He continues to say that, while corporations have other compensation tools, they are inadequate because they are set in advance, and fair compensation should match individual contributions.²⁴ Salary, special bonuses, or stock options are not compensatory enough to meet the ambition, enthusiasm, and self-confidence of employees and do not "serve the needs of the entrepreneur for the massive reward for great innovations."²⁵

1.2 *Insider trading will add more players to the market:*

Professor Manne also argues that insider trading allows any individual who works for a publicly traded corporation to play an entrepreneurial role, which is an important advantage.²⁶ Individuals can, in effect, sell their own ideas without the necessity of having a large amount of capital available.²⁷ This also serves as an economic function that benefits the corporation; it will allow imaginative employees to take risks and be less conservative.²⁸

Professor Manne's thesis has been criticized through the years. Scholars responding to Manne's thesis contend that insider trading is an inadequate method for compensating corporate managers. Initially, there are trading hedge rules for the stock market that limit risk. If we accept Professor Manne's thesis, then insiders hoping for massive personal profit will devalue any trading rules, customs, and principles, and this could cause a disaster for the entire market. Easterbrook further explained that permitting insider trading practices would increase the number of people engaging in unreasonably risky business activities.²⁹ He continued analyzing the inadequacy of presumed managers and the rewards system saying that there is a difference between

¹⁹ Henry G. Manne, *In Defense of Insider Trading*, 44(6) HARV. BUS. REV. 113 (1966).

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, SUP. CT. REV. 309, 332 (1981).

investors and managers in terms of risk factors related to stock prices.³⁰ Investors are free to invest in a portfolio to reduce risk, which makes them less sensitive to stock price volatility.³¹ However, because managers do not have the option to diversify, they are more sensitive to the volatility of stock prices.³² That leads us to the fact that “most managers would prefer the certainty of \$100,000 salary to a salary of \$50,000 and a 10 percent chance of a bonus of \$500,000.”³³

Furthermore, permitting insider trading may become an incentive for managers to accept and tolerate losses and negative developments instead of striving to overcome them because they can benefit from bad news as well as good news.³⁴ Finally, the positive contributions and developments that business managers bring to their corporations are closely examined and appreciated by the entire financial system. Big corporations will fight to hire smart managers, officers, and key employees whose activities add value to corporations no matter how expensive their salaries, bonuses, stock options, or other types of compensation are.³⁵ Hence, saying that insider trading is the best and most adequate compensation method for corporate innovators is no longer plausible.

1.3 *Insider trading contributes to market efficiency:*

Carlton and Fischel argued that stock market efficiency is another reason to advocate for insider trading.³⁶ They argued that insider trading plays the same role as disseminated information in terms of informing the shareholders and consequently influencing the price of stocks.³⁷ They claim that when an insider trades, the stock price will reflect this change as if the information has been disclosed.³⁸ The more disclosure for the identity of the insider, the closer the stock reflects its true price.³⁹ This means corporations

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 5 (1982).

³⁵ Broadcom paid its CEO Hock Tan a total compensation package of \$103.2 million. See Kathleen Elkins, *Median CEO pay reaches \$12.1 million – here’s how much the 4 highest-paid leaders earn*, CNBC (May 9, 2018) <https://www.cnn.com/2018/05/09/how-much-the-5-highest-paid-ceos-earn.html>.

³⁶ Daniel R. Fischel and Dennis W. Carlton, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1982).

³⁷ *Id.*

³⁸ *Id.*

³⁹ U.S. brokerage firms publish corporation's insider transactions as an indicator to inform investors about stock's future price. See, ROBINHOOD, <https://robinhood.com/> (last visited Mar. 26, 2020).

can control the stock price by controlling the communication of information through insider trading.

The application of this theory is inapplicable because it assumes that insider trading is a disclosure tool; it assumes that the corporation utilizes insider trading to tell the shareholder and the interested public that developments occurred, so watch how the insiders trade and react accordingly. Also, this assumes that insiders always put their corporation's interests before their personal interests, and that is rare in humans. Besides, what if an insider's transactions were fabricated, intended only to manipulate the price, and there is no actual ground for price change? How would we assess the accuracy of this disseminated information as we do with prospectuses or corporations' periodic reports? Who will be liable in cases of violations; the insider who traded or the corporation?

2. *Why insider Trading should be Prohibited?*

Securities literature presents four main policy justifications for prohibiting insider trading: fairness, market integrity, enhance prompt disclosure, and property protection.

2.1 *Insider trading is not fair:*

Insider trading is not fair because it harms the investor, the issuer, the bidder in cases of tender offers or mergers, and market participants, such as broker-dealers.⁴⁰ Focusing our discussion over the first person affected by insider trading, we will look from the stockholder's side. The fairness approach is based on the parity of information that should exist between two parties for any normal transaction. However, information parity does not mean—as the SEC proposed—that transaction parties should stand on the same level of knowledge, or “level playing field,” about the securities transactions.⁴¹ Instead, fairness means there is no asymmetry of information access to the securities forgo prices because of firm-specific information, not because of general market conditions.⁴² This means the issue is not the

⁴⁰ *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). The trial court in *Fridrich v. Bradford*, held that the insider trader had breached a duty to the entire market, and set damages representing the “losses” of all traders who had sold during the period from the insider's purchase until the disclosure. *Id.*

⁴¹ “The law has no patience with plaintiffs who are foolish or overcautious.” *Grant v. Attrill*, 11 F. 469, 470 (C.C.S.D.N.Y. 1882) (“The [plaintiff] seems to have preferred to sell rather than risk the management promised; and he sold out”); *see* Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289 (1998).

⁴² William J. Carney, *Signaling and Causation in Insider Trading*, 36 Cath. U. L. Rev. 863 (1987). *See also*, Chief Justice Marshall's notice in *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 195 (1817), if there is no superiority in terms of information

information asymmetry itself but how the information is obtained; trading based on good faith effort to understand the forego market prices is permitted, while trading based on stolen information is prohibited.⁴³ Professor William J. Carney investigated the causation of investor injury because of insider trading.⁴⁴ He concluded, “The loss of an investor is caused by the revelation of truthful information, which he or she lacked at the time of trading, and which causes the market to revalue the particular issuer's shares.”⁴⁵ Whether the transaction was face-to-face or in person “investors are directly solicited, the insider has in fact induced the other person to transact with him or her, and causation is relatively clear.”⁴⁶ The trial court in *Fridrich v. Bradford*, applied this understanding and held that the insider trader breached a duty to the entire market, and set damages representing the “losses” of all traders who had sold their stocks during the period from the insider's purchase until the disclosure.⁴⁷ The Court in *United States v. O'Hagan* stated, “A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.”⁴⁸

When insiders remain silent about material information pertaining to the transaction of their corporation's securities, they commit deception and cheat the shareholders, who placed their trust and confidence in them and expected them to speak.⁴⁹ Finally, saying that insider trading should be considered a reward for performance would open the door for fraud and affect market efficiency.

2.2 *Insider trading negatively affect market confidence:*

The Supreme Court in *United States v. O'Hagan* used very clear language to warn against how insider trading undermines investor confidence and impact negatively the entire economic system. The Court said, “Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.” The Supreme Court also emphasized that “if the market is thought to be systematically populated with ... transactors -trading on the basis of misappropriated information- some investors will refrain from dealing altogether, and others

accessibility “[i]t would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties.”

⁴³ William J. Carney, *Signaling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 864 (1987).

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ 429 U.S. 1053 (1977).

⁴⁸ U.S. v. O'Hagan, 117 U.S. 2199 (1997).

⁴⁹ Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009).

will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages.”⁵⁰

Furthermore, from an economic view, if insiders were allowed to transact based on inside knowledge they would induce or prevent a securities transaction that was not going to be executed if there was no insider trading. In the long run, these transactions cause stock market flow to shift from its economic normal format, and consequently widen the distance between the economic reality of stocks and its trading prices. This fictitious shift will cause stock prices to be either underpriced or overpriced and this will undermine market confidence.

Laura Beny conducted an empirical study on 33 countries, including highly developed and newly emerging stock markets.⁵¹ The study proved that countries that had a robust prohibitive system against insider trading enjoyed “ownership dispersion, stock price informativeness, and stock market liquidity.”⁵²

2.3 *Prohibiting insider trading enhances prompt disclosure.*⁵³

Disclosure plays a crucial role in building an efficient stock market. Market efficiency means that stock information—both public and private—is fully reflected in its prices. The more efficient markets can become, the more closely stocks’ intrinsic value is reflected in its prices. Corporations used to make selective disclosures to certain securities market professionals. These practices prompted the SEC to enact Regulation Fair Disclosure (Reg FD) to mandate public companies’ simultaneous disclosures to the public when corporate officials first made selective disclosures to a privileged few. This regulation applies to persons like brokers or dealers, investment advisers, personnel of an investment company, any persons who owe a duty of trust or confidence, or any other associated persons. Rule 100(b) of regulation FD allows disclosure to insiders or temporary insiders and exempts them from selective disclosure prohibitions.

Express liability of insider trading prompts, to a certain level, those who are potentially liable to make timely public disclosure, so they avoid potential charges. Hence, the point is that if insiders to the material nonpublic

⁵⁰ *O’Hagan*, 521 U.S. at 654.

⁵¹ Laura N. Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237 (2007).

⁵² *Id.*

⁵³ See the argument that insider trading plays the same role as disseminated information and the counterargument we presented. *Supra* Section 1.3.

information cannot trade while business secrets exit, they will be motivated to release information promptly and widely.

2.4 *Prohibiting insider trading enhance private property protection:*

A corporation's important nonpublic information is an intangible asset owned by the corporation and, by extension, to all of its shareholders. Title transfer of valuable information or an "intangible asset" or depleting it for the insiders' private benefit is more or less a kind of property theft. The rationale for assigning property rights to valuable information for the stockholder or the corporation is the same as the rationale in prohibiting patent infringement.⁵⁴

Corporations will only be incentivized to innovate and engage in strategic decisions if they can capture the value of these investments without the fear of theft. Courts permit shareholders private action for insiders trading in order to protect shareholders' property interest in a corporation's nonpublic information.⁵⁵

II. THE OFFENSE OF INSIDER TRADING

A. *Classical and Misappropriation Theories in American Federal Courts, Fraud in Connection with the Purchase or Sale of Security Rule (10b-5).*

Fraudulent nondisclosure was the earliest lawsuit shareholders brought in the United States courts against corporate officers.⁵⁶ Although fraudulent conduct under common law requires an affirmative misstatement and reliance to prove fraud,⁵⁷ courts recognized that, in certain circumstances, pure silence about material information could be sufficient to plead fraud.⁵⁸ One of these circumstances is when there is a fiduciary relationship between the two parties to a transaction. Courts, at this time, varied in evaluating these circumstances for what is called the "majority rule" and "minority rule." Under the majority rule, insiders owe a fiduciary duty to the corporation only, not to the shareholders. This means insiders are free to use "material nonpublic

⁵⁴ Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice between Property Rights and Securities Fraud*, 52 S.M.U. L. Rev. 1589,1606–08 (1999).

⁵⁵ *Shapiro v. Merrill Lynch*, 495 F.2d 228 (2nd Cir. 1974), the court accepted the implied cause of action of insider trading and limited the right of action to shareholders who had traded contemporaneously with the insider.

⁵⁶ Donna M. Nagy, Richard W. Painter, and Margaret V. Sachs, *Securities Litigation and Enforcement: Cases and Materials*, 4th Edition (2017).

⁵⁷ *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 195 (1817), Chief Justice Marshall stated parties to transactions have no affirmative duty of disclosure.

⁵⁸ Nagy, Painter, Sachs, *supra* note 56, at 490.

information” in transactions with the corporation’s shareholders without any disclosure obligations.⁵⁹ Meanwhile, under the “minority rule,” insiders are fiduciaries for both the corporation and the shareholders and thus, insiders cannot remain silent about material nonpublic information.⁶⁰ Yet, under the minority rule, there are still certain prerequisites for fiduciary obligation, like face-to-face transactions and transacting with a party who had a pre-existing relationship with the corporation. In *Goodwin v. Agassiz*,⁶¹ the court said an insider trading violation would not exist if the identity of the insider was unknown to the buyer (the shareholder) and there was no face-to-face transaction.

Before enacting the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), courts used to adjudicate securities fraud disputes under Common Law and the Criminal Code.

The United States Supreme Court shaped and endorsed Classical and Misappropriation theories of insider trading in three cases: *Chiarella v. United States*⁶² in 1980, *Dirks v. SEC*⁶³ in 1983, and *United States v. O’Hagan*⁶⁴ in 1997. We will closely examine these three cases through the coming chapter.

1. *The Classical Theory of Insider Trading*

Traditional, special relationship or classical theory were the terms that courts used to refer to the offense of insider trading when there was a relationship between the corporate insider and the buyer or seller of securities of that corporation.⁶⁵ In *Dirks v. SEC*, the Supreme Court referred to a “special relationship” between the insider of the corporation and its shareholders.⁶⁶

⁵⁹ *Bawden v. Taylor*, 254 Ill. 464 (1912). The plaintiff prayed to set aside the stock sale under the Criminal Code, prohibiting gambling in stocks, the court said, “officer of corporation is not a trustee for stockholders as respects their stock.” Officers are trustees for the stockholders as a body not for an individual stockholder. *Id.*

⁶⁰ *Dawson v. Nat’l Life Ins. Co.*, 157 N.W. 929, 938 (Iowa 1916).

⁶¹ *Goodwin v. Agassiz*, 186 N.E. 659, 660 (Mass. 1933).

⁴³ *Chiarella v. United States*, 445 U.S. 222 (1980). *Chiarella* consider the source of the “classical” or “traditional” theory of insider trading liability.

⁶³ *Dirks v. SEC*, 463 U.S. 646 (1983).

⁶⁴ *United States v. O’Hagan*, 521 U.S. 642 (1997). Prior to *O’Hagan*, a majority of the Court had recognized Section 10(b) and Rule 10b-5 liability for insider trading only under the classical theory. See Donna M. Nagy, “*Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O’Hagan Suggestion*”, MAURER SCH. OF L. 1223 (1998).

⁶⁵ William K.S. Wang & Marc I. Steinberg, *Insider Trading*, 52 THE BUS. LAW. 1431 (1997).

⁶⁶ Wang & Steinberg, *supra*, note 17, at 291.

This special fiduciary relationship was the basis of the classical theory for insider trading.⁶⁷

The Supreme Court in *Chiarella v. United States* defined the elements of insider trading under classical theory, which defines who the insider is, to whom the insider owes the fiduciary duty, and what the limits of their liabilities are.⁶⁸

The facts of *Chiarella v. United States* came as the petitioner, Vincent Chiarella, was employed by a financial printer that engaged to print corporate takeover materials.⁶⁹ Chiarella deduced the names of the target corporation before receiving the true names on the final printing night.⁷⁰ He purchased stock in the target companies and after the takeover went public, he profited from selling the purchased shares.⁷¹ After an SEC investigation, Chiarella entered into an agreement with the SEC to return the profits he made to the sellers of the shares.⁷² Thereafter, he was indicted and convicted for violating Section 10(b) and Rule 10b-5—as the jury was instructed—because he willfully failed to disclose to the sellers of the target company the inside information about the forthcoming takeover bid.⁷³

1.1 *The Supreme Court ruling on Chiarella:*

The Supreme Court reversed the Second Circuit conviction and ruled that Chiarella's conviction under Section 10(b) was improper because the liability under Section 10(b) is premised upon a duty to disclose arising from a relationship of trust between parties to a transaction.⁷⁴ Because Chiarella was not an insider and did not owe the acquired corporation shareholders a duty to disclose, he also was not a fiduciary for the sellers of the target corporation because they had not placed their trust in him.⁷⁵ The Supreme Court said Chiarella's conviction could not be justified on the alternative theory under Rule 10b-5 that he breached a fiduciary duty to the acquiring corporation to whom Chiarella owed a duty of trust because such a theory was not presented to the jury.⁷⁶

⁶⁷ Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, Harv. L. Sch. F. on Corp. Governance (Sept. 30, 2016), <https://corpgov.law.harvard.edu/2016/09/30/a-unified-theory-of-insider-trading-law/>.

⁶⁸ *Chiarella*, 445 U.S. at 222.

⁶⁹ *Id.* at 224.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.* at 225.

⁷⁴ *Id.* at 236–37.

⁷⁵ *Id.* at 232–33.

⁷⁶ *Id.* at 236–37.

The Supreme Court said there is no such evidence from the language or the legislative history of Section 10(b) that can form such a broad disclosure duty between all participants in market transactions based on the mere possession of material, nonpublic information.⁷⁷ Instead, there is a detailed securities regulation that recognizes when such use of nonpublic information may not harm the efficiency of the stock market.⁷⁸ Hence, classical theory liability requires a duty to disclose, and that this duty arises from a relationship of trust and confidence between parties to a transaction. Since the sellers of the target corporation stocks did not put their trust in Chiarella, the Supreme Court reversed the indictment saying there was no “general duty between all participants in market transaction to forgo actions based on material, nonpublic information.”⁷⁹ However, insiders such as officers and directors of the corporation whose stock is traded do owe such duties to the corporation’s shareholders.⁸⁰ The Court left open the possibility of Chiarella’s indictment under other theories because they were not included in the jury instructions.

Justice Burger dissented saying the language of Section 10(b) and Rule 10b-5 which says “[A]ny person [engaged in] . . . any [fraudulent] scheme”⁸¹ would encompass any person who misappropriated nonpublic information, and that person has an absolute duty to disclose or abstain from trading. It is not only limited to corporate insiders.⁸²

1.2 *Dirks v. SEC*⁸³

In *Dirks v. SEC*, the U.S. Supreme Court reversed the D.C. Court of Appeals insider trading judgement against Dirks, who was an officer of a New York broker-dealer firm specialized in analysis of insurance companies’ securities.⁸⁴ Ronald Secrist, a former officer of an insurance company incentivized by verifying and exposing fraud, gave Dirks inside information about how overstated his insurance company’s assets were.⁸⁵ Based on Secrist’s information, Dirks started his own investigation and during this stage of investigation, he openly discussed that information with a number of his clients.⁸⁶ Neither Dirks nor his firm owned or traded that insurance company’s stocks, but some of his clients sold their stocks based on his tips before the

⁷⁷ *Id.*

⁷⁸ 15 U.S.C. § 78m(d)(1) (Supp. II 1976). *Williams Act* allows for a certain limit the bidder in tender offer to trade on the target corporation before announcing the tender offer.

⁷⁹ *O’Hagan*, 521 U.S. at 661.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Chiarella*, 445 U.S. at 236–37.

⁸³ *Dirks v. SEC*, 463 U.S. 646 (1983).

⁸⁴ *Id.*

⁸⁵ *Id.* at 649.

⁸⁶ *Id.*

stock price fell.⁸⁷ The SEC charged Dirks with securities fraud under Section 10(b) and Rule 10b-5, alleging that he aided and abetted his clients to sell their stocks in the insurance company based on material, nonpublic information conveyed by company insiders.⁸⁸

The Supreme Court reaffirmed *Chiarella v. United States*, acknowledged its violation elements,⁸⁹ and added that Rule 10b-5 also requires a scheme of “manipulation or deception” to make personal profits.⁹⁰

1.3 *Elements of Section 10(b) and Rule 10b-5’s Violation Under*

Classical Theory

Chiarella set the precedent that a violation of Section 10(b) and Rule 10b-5 by corporate insiders requires a breach of a disclosure duty that arises from a relationship of trust and confidence between the transaction parties.⁹¹ This requires, first, that the existence of such a relationship affords access to inside information intended to be available only for the corporation’s purposes, and second, that it will be unfair to allow a corporate insider—or a co-participant—to take advantage of that information by trading without informing the victim.

1.4 *Can Silence Constitute a Manipulative or Deceptive Device?*

Section 10(b) and Rule 10b-5 require the use of a “deceptive device” in connection with a securities transaction to be charged with insider trading. At this point, can pure silence be sufficient to plead securities fraud under Section 10(b) and Rule 10b-5, thereunder?

Neither the language of Section 10(b) nor Rule 10b-5 answers this question. The Second Circuit found in *Frigitemp Corp. v. Fin. Dynamics Fund, Inc.* that “the party charged with failing to disclose market information must be under a duty to disclose.”⁹² Thus, silence in connection with securities transactions may be considered fraud under Section 10(b) when there is a duty to disclose arising from a relationship of trust and confidence between

⁸⁷ *Id.*

⁸⁸ *Id.* at 650–51.

⁸⁹ *Id.* at 646–47. There are “[t]wo elements for establishing a violation of § 10(b) and Rule 10b-5 by corporate insiders [which] are the existence of a relationship affords access to inside information intended to be available only for corporate purpose, and the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.” *Id.*

⁹⁰ *Id.* at 647.

⁹¹ *Chiarella*, 445 U.S. 222.

⁹² *Frigitemp Corp v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975).

transaction parties.⁹³ In *Affiliated Ute Citizens v. United States*, the Court held that the bank agent had a duty to inform its mixed-blood Indian customers that their shares could be sold for a higher price on a non-Indian market.⁹⁴ The bank agent's duty to inform arose from the trust that the Indian customers placed in him.⁹⁵ Hence, silence may constitute a manipulative or deceptive device when there is a relationship of reliance and trust.

1.5 *Who is an Insider Under Classical Theory?*

The Supreme Court in *Dirks v. SEC* indicated that liability under the classical theory applies to not only officers, directors, and other permanent insiders of the corporation, but also to "temporary insiders" or "quasi-insiders," such as attorneys, accountants, and investment bankers who become temporary fiduciaries of the corporation.⁹⁶ In *Dirks*, the Supreme Court developed the idea of temporary insiders, stating that

[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.⁹⁷

Further, the issuer may be included in the circle of classical theory and treated as an insider. Courts have treated corporations trading on the basis of inside information to benefit the corporation itself as any person subject to the disclose or abstain rule.⁹⁸

1.6 *Possession vs. Use*

Under the classical theory, liability requires insider trading to take place while "in possession of" material, nonpublic information. However,

⁹³ Nagy, Painter, Sachs, *supra* note **Error! Bookmark not defined.**, at 517.

⁹⁴ *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152–53 (1972).

⁹⁵ *Id.*

⁹⁶ 463 U.S. at 655.

⁹⁷ *Id.* at n.14.

⁹⁸ The term "insider" is also used to describe persons such as attorneys, and other professionals who work as temporary agents of the corporation (sometimes termed "temporary insiders" or "quasi-insiders"). See Wang & Steinberg, *supra* note **Error! Bookmark not defined.**, at 303; see also *Chiarella*, 445 U.S. 222.

questions remain whether one must possess material, nonpublic information in all occasions and whether one must disclose or abstain from trading, if one is only barred from using this information in trading. Whether liability for insider trading under Rule 10b-5 should be determined pursuant to a “knowing possession” test or a “use” test is still debated.⁹⁹

In *SEC v. Adler*¹⁰⁰ and *United States v. Smith*,¹⁰¹ the two federal courts rejected the SEC possession standard and ruled that Rule 10b-5 only prohibits trading *on the basis* of material, nonpublic information.¹⁰² Therefore, if a person trades while in the possession of material, nonpublic information, the government still needs to prove that the person actually used the inside information in a trading decision.

However, in *United States v. Teicher*,¹⁰³ the Second Circuit reached the opposite ruling and stipulated “a knowing possession” for three reasons: first, Section 10(b) and Rule 10b-5 only require that a deceptive practice be conducted “in connection with the purchase or sale of a security”—the “in connection with” clause must be “construed flexibly to include deceptive practices ‘touching’ the sale of securities.”¹⁰⁴ Second, a “knowing possession” standard comports with the maxim that one with a fiduciary or similar duty to hold material, nonpublic information in confidence must either “disclose or abstain.”¹⁰⁵ Finally, a “knowing possession” standard has the attribute of simplicity, recognizing that one who trades while knowingly possessing material, inside information has an informational advantage over other traders.¹⁰⁶

The SEC did not wait for this conflict to be solved through case-by-case adjudication. The SEC opted to use its authority under Section 10(b) to promulgate Rule 10b-5-1 to endorse a “knowing possession”¹⁰⁷ with an affirmative defense in Rule 10b-5-1(c)(1)(i), which provides that a purchase

⁹⁹ Nagy, Painter, Sachs, *supra* note 56, at 546.

¹⁰⁰ 137 F.3d 1325 (11th Cir. 1998).

¹⁰¹ 155 F.3d 1051 (9th Cir. 1998).

¹⁰² The court summarized the SEC’s position stating that

[t]he Commission also believes that Rule 10b-5 does not require a showing that an insider sold his securities for the purpose of taking advantage of material nonpublic information If an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of the public.

See Report of the Investigation *In the Matter of Sterling Drug Inc.*, SEC Release No. 14675 (April 14, 1978).

¹⁰³ 987 F.2d 112 (2d Cir. 1993).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ Nagy, Painter, Sachs, *supra* note **Error! Bookmark not defined.**, at 517.

or sale is not “on the basis of” material, nonpublic information if there was a predetermined plan for the sale or purchase of securities. This includes entering into a good faith, binding contract for the sale or purchase of securities, instructing another person to transact on the account owner’s behalf, or adopting a written plan for trading securities.¹⁰⁸

2. *The Misappropriation Theory of Insider Trading*

The misappropriation theory was introduced to protect the integrity of security markets from outsiders who have access to a corporation’s secrets but owe no fiduciary duty to the corporation’s shareholders.

According to the misappropriation theory, one commits insider trading securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5 when one, “in connection with” a securities transaction, misappropriates confidential information in a breach of duty of loyalty and confidentiality owed to the source¹⁰⁹ of information who owns the exclusive use of that information.

2.1 *United States v. O’Hagan*¹¹⁰

In *United States v. O’Hagan*, the United States Supreme Court was confronted with similar facts as in *Chiarella v. United States*, but in *O’Hagan*, the court was not restricted by limited jury instructions.

James O’Hagan was a partner in the law firm of Dorsey & Whitney that was hired to represent Grand Metropolitan PLC on a potential tender offer.¹¹¹ While Dorsey & Whitney law firm was still retained to represent Grand Metropolitan, O’Hagan started purchasing call options for the target company stocks.¹¹² When the tender offer was publicly announced, O’Hagan sold his stock for a profit of \$4.3 million.¹¹³ The SEC charged O’Hagan, *inter alia*, for misappropriating material, nonpublic information for personal benefit and defrauding Grand Metropolitan PLC and the Dorsey & Whitney law firm who was working for the bidder.¹¹⁴ The indictment charged O’Hagan with the violation of Section 10(b) and Rule 10b-5 for fraudulent trading in connection

¹⁰⁸ See Rule 10b-5-1(c)(1)(i).

¹⁰⁹ Professor Nagy suggests a broader “fraud on investors” version of the misappropriation theory, she says investors in the marketplace are also deceived and defrauded when a person purchases or sells securities based on material, nonpublic information that has been misappropriated from the information’s source. See Nagy, Donna M., “*Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O’Hagan Suggestion*” (1998). Articles by Maurer Faculty. Paper 615., at 1223.

¹¹⁰ *O’Hagan*, 521 U.S. 642.

¹¹¹ *Id.* at 647.

¹¹² *Id.* at 647–48.

¹¹³ *Id.* at 648.

¹¹⁴ *Id.* at 648–49.

with a tender offer in violation of Section 14(e) of the Exchange Act and SEC Rule 14e-3(a).¹¹⁵ O’Hagan was convicted and sentenced to prison.¹¹⁶

The Eighth Circuit reversed O’Hagan’s conviction, holding that Section 10(b) and Rule 10b-5 liability may not be grounded on the misappropriation theory.¹¹⁷ Further, the Eighth Circuit said misappropriation theory is inconsistent with Section 10(b), and under *Chiarella* and *Dirks* ruling, “Only a breach of a duty to parties to a securities transaction, or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability.”¹¹⁸

The United States Supreme Court reversed and remanded the Eighth Circuit decision and ruled that a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, will be found guilty of violating Section 10(b) and Rule 10b-5.¹¹⁹ The United States Supreme Court said the Eighth Circuit erred in holding that the misappropriation theory is inconsistent with Section 10(b) because the deceptive nondisclosure is essential to Section 10(b) liability under the theory. Hence, it was O’Hagan’s failure to disclose his personal trading to Grand Met and Dorsey while he is required to speak that made his conduct “deceptive” under Section 10(b).

The Supreme Court further explained that

[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.¹²⁰ The misappropriation theory bars only “trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information.”¹²¹

¹¹⁵ *Id.* at 649.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 661.

¹¹⁹ *Id.* at 665–66.

¹²⁰ *Id.* at 653.

¹²¹ *Id.* at 665.

2.2 *Elements of Section 10(b) and Rule 10b-5's Violation Under
Misappropriation Theory.*

The Supreme Court in *O'Hagan* emphasized three elements: (1) deceptive conduct of material nonpublic information, (2) in connection with a securities transaction, and (3) scienter and willfulness in criminal action.¹²² The Court affirmed and endorsed the criminal liability under Section 10(b) on the misappropriation theory.¹²³ The court held that liability under misappropriation theory meant that a Section 10(b) and Rule 10b-5 violation occurred when an outsider traded based on nonpublic, confidential information in breach of a fiduciary duty owed to the *source* of the information, rather than to the person with whom he traded.¹²⁴ *O'Hagan* emphasized that section 10(b) liability requires deceptive conduct of material nonpublic information, in connection with a securities transaction, and scienter.¹²⁵

i. *First Element: Deceptive Conduct*

The Supreme Court defined deception as “[a] fiduciary who pretends loyalty to the principal while secretly converting the principal’s information for personal gain dupes or defrauds the principal.”¹²⁶ So, if the fiduciary informed the source of information that he planned to trade based on secret information he had, there is no deceptive device and, consequently, the liability under misappropriation theory will be foreclosed because there is no “deceptive device.”¹²⁷

ii. *Second Element: In Connection with the Purchase or Sale of*

Security

The misappropriation’s deceptive use must be “in connection with the purchase or sale of securit[y],” which means that information had to be used in purchasing or selling securities and not for any other uses.¹²⁸ In *SEC v.*

¹²² *Id.* at 643.

¹²³ *Id.* at 652.

¹²⁴ *Id.*

¹²⁵ In *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 568 U.S. 455 (2013), investors brought putative class action against corporation and individual officers and directors alleging securities fraud. The court enumerated six elements of an implied § 10(b) cause of action for securities fraud: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

¹²⁶ *O'Hagan*, 521 U.S. at 642.

¹²⁷ *Id.* at 653.

¹²⁸ *Id.* at 658.

Clark,¹²⁹ the court said Section 10(b) and Rule 10b-5 do not proscribe all frauds occurring in the business world, only those “in connection with the purchase or sale of any security.”¹³⁰

iii. *Third Element: Scienter and Willfulness in Criminal Action*

Scienter is a required element in every case involving fraud that esteems from the common law and Rule 10b-5 adopts that element whether the SEC or U.S. attorney brings the insider trading case.¹³¹ However, in prosecuting insider trading, criminally proving willfulness conduct is required in addition to scienter.¹³² The United States Supreme Court defined Scienter in *Ernst & Ernst v. Hochfelder* as “a mental state embracing intent to deceive, manipulate, or defraud.”¹³³

The Supreme Court in *O’Hagan* concluded that misappropriation theory was consistent with the statute and precedent and establishing criminal violation of Rule 10b-5 under the misappropriation theory would require proving the presence of culpable intent (scienter), which means that the defendant “willfully” and with knowledge of Rule 10b-5 committed the violation.¹³⁴ The defendant will not be imprisoned if he can prove his lack of knowledge of the rule.¹³⁵

Hence, the scienter element is necessary to prove violation of Section 10(b) and Rule 10b-5.¹³⁶ Negligence will not suffice to constitute a violation of Section 10(b) and Rule 10b-5; however, actual intent will satisfy this element.¹³⁷ The overwhelming majority of the circuit courts concluded that recklessness is also enough in non-criminal cases.¹³⁸ Some courts established a three elements formula for scienter of an insider trading case.¹³⁹ The three elements are actual knowledge of nonpublic, material information, knowledge that the information was undisclosed, and knowledge that the information was material.¹⁴⁰ If the liability of insider trading was based on the misappropriation theory, the tippee must also know that the tipper disclosed the inside,

¹²⁹ *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

¹³⁰ *Id.*

¹³¹ *O’Hagan*, 521 U.S. at 66566.

¹³² *Id.*

¹³³ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

¹³⁴ *O’Hagan*, 521 U.S. at 665–66.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* at 666.

¹³⁸ *Wang & Steinberg*, *supra* note 17, at 42.

¹³⁹ *Id.*; *see SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983).

¹⁴⁰ *MacDonald*, 699 F.2d 47.

nonpublic information on a breach of fiduciary duty to the source of information.¹⁴¹

*B. The Concept of Tipping Under Dirks v. SEC*¹⁴² (1983) and *Salman v. United States*¹⁴³ (2016)¹⁴⁴

Tipping occurs when an insider passes on information that he knows is material and nonpublic to an outsider, in violation of a fiduciary duty to the issuer or the source of the information.¹⁴⁵ The United States Supreme Court established a test for securities fraud responsibility of the person who receives material, nonpublic information in *Dirks* and reaffirmed this test in *Salman v. United States*.¹⁴⁶ We are going to define the concept of tipping and the element of personal benefits.

I. Tipping Under Dirks v. SEC (1983)

The United States Supreme Court in *Dirks v. SEC* extended the liability of insider trading to the temporary employee or agent of the corporation and to persons “called tippees” and made them obliged under the disclose or abstain rule.¹⁴⁷ A tippee is a person who receives information from the “tipper” in breach of fiduciary duty to shareholders.¹⁴⁸ The court made it clear that if a tippee trades on nonpublic information received from an insider or someone who, in turn, received it from an insider “tipper,” and the “tippee” knows that the information was disclosed in violation of the tipper’s fiduciary duty, he might be found liable for committing insider trading under Section 10(b) and Rule 10b-5.¹⁴⁹ The Court defined tippees as “those individuals who trade securities of a company while in possession of material, nonpublic information about that company (a “tip”) that was conveyed by a corporate insider in violation of his fiduciary duty to the company’s shareholders.”¹⁵⁰ That means the tippee, by obtaining the tip, will inherit a derivative obligation

¹⁴¹ *O’Hagan*, 521 U.S. at 673–78.

¹⁴² *Dirks v. SEC*, 463 U.S. 646 (1983).

¹⁴³ *Salman v. United States*, 137 S. Ct. 420 (2016).

¹⁴⁴ We did not discuss tipping as a classical theory problem and misappropriation problem separately. When the tipper violates a fiduciary duty to the issuer, this will be a classical theory of insider trading, and when the tipper violates a duty to the source of information, that will be misappropriation theory. Many times, the two theories come together because when a tipper violates a fiduciary duty to the issuer, the issuer is also the source of information.

¹⁴⁵ *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1978).

¹⁴⁶ 137 S. Ct. at 420.

¹⁴⁷ *DoNagy*, *supra* note 49, at 1317.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Elkind v. Liggett & Myers, Inc.*, 472 F. Supp. 123 (S.D.N.Y. 1978), *aff’d* in part, *rev’d* in part, 635 F.2d 156 (2d Cir. 1980).

of fiduciary duty to the company's shareholders from the tipper, and that obligation requires the tippee to adhere to the disclose or abstain rule, same as the insider. The question before the Supreme Court was whether or not *Dirks*, as a tippee, violated anti-fraud laws by disclosing the material information he received from the tipper to his clients.¹⁵¹

The Court set an objective criterion in *Dirks* saying "the tippee" would be held liable under the disclose or abstain rule if the "tip" breached a fiduciary duty and that breach occurred for the sake of personal benefits.¹⁵² Since the insurance company former insider (the tipper) did not breach his fiduciary duty to the company's shareholders by providing insider information to the tippee, the tippee does not inherit the duty to disclose or abstain and there is no derivative breach.¹⁵³

The Court said that determining if a disclosure is a breach of duty depends, in large part, on the purpose of the disclosure, which means scienter is an independent element of a Rule 10b-5 violation under classical theory.¹⁵⁴

The Court said not all breaches of fiduciary duty in connection with a securities transaction come within the ambit of Rule 10b-5.¹⁵⁵ The tipper may disclose inside information, but still act consistently with his fiduciary duty.¹⁵⁶ For instance, if the tipper does not anticipate that the tippee will trade on the basis of disclosed information or the tipper does not recognize that the tip is material and may constitute nonpublic information.

So, the manipulation or deception element is required to constitute unfairness when the insider takes advantage of information intended to be available only for a corporation's purposes. The tippee's responsibility must be related back to the insider's responsibility by showing that the tippee knew that the information was given to him in breach of a fiduciary duty to the stockholder (under classical theory) or to the source of information (under misappropriation theory).¹⁵⁷

In determining whether a tippee is under an obligation to disclose or abstain, it is necessary to determine whether the insider's "tip" constitutes a breach of the insider's fiduciary duty.¹⁵⁸

¹⁵¹ *Dirks v. SEC*, 463 U.S. 646, 648 (1983).

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 663–64.

¹⁵⁵ *Id.* at 664

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 661.

¹⁵⁸ *O'Hagan*, 521 U.S. at 669.

Dirks adopted—but read it differently than SEC—the Cady, Roberts¹⁵⁹ formulation of the breach of duty in which the transmission of information that was made available only for a corporate purpose for personal benefits, with the intent and knowledge that the individual is going to trade.

The *Dirks* court also emphasized the *Chiarella* ruling saying that there can be no duty to disclose where the person who has traded on inside information “was not [the corporation’s] agent . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.”¹⁶⁰ This does not mean the tippee is free to trade. The tippee might inherit the tipper’s liability if the tip was in breach of the tipper’s fiduciary liability. Since the tip does not breach the former insider fiduciary obligation to the insurance company, petitioner—Dirks—who received the material, nonpublic information from an “insider” of a corporation with which he had no connection, does not inherit the insider liability.¹⁶¹ Besides, the tipper was motivated by a desire to expose fraud, received no monetary or personal benefit from revealing the information, and their purpose to make a gift of valuable information to the petitioner.¹⁶² Thus, there was no actionable violation of anti-fraud provisions of federal securities laws resulting from the petitioner’s disclosure to his clients who relied on it in trading shares of the corporation.¹⁶³

2. *Why the Supreme Court Vacated Court of Appeal Dirks Finding of*

Illegal Insider Trading:

First, from Ronald Secrist’s (the tipper’s) side, there was no culpability in sharing the nonpublic information with Dirks because the tipper believed that the information was transmitted for a proper purpose (exposing the company fraud) and he did not receive or expect to receive a direct or indirect personal benefit from his disclosure.¹⁶⁴

Second, from Dirks’ side, initially he did not owe the company stockholders a fiduciary duty and there is no fiduciary duty breach to be inherited from the insider.¹⁶⁵ Besides, the manipulative and deceptive element were not clear from Dirks’ actions, it seems that the court interpreted Dirks’ disclosure to some of his clients as incidental in his main purpose of striving

¹⁵⁹ *In Re Cady & Roberts & Co.*, 40 S.E.C. 907 (1961). In this case the court held that the defendant tippees did not violate any fiduciary duties concerning stock purchases where the SEC failed to prove that an insider revealed information for an “improper purpose.” *Id.*

¹⁶⁰ *O’Hagan*, 521 U.S. at 645.

¹⁶¹ *Id.* at 671–72.

¹⁶² *Id.* at 672.

¹⁶³ *Id.*

¹⁶⁴ *Id.* at 676.

¹⁶⁵ *Id.* at 665.

to expose fraudulent corporate practices.¹⁶⁶ That means there is no scienter, which is necessary to prove the violation of Section 10(b) and Rule 10b-5.¹⁶⁷

3. *Personal Benefits Test Under Dirks*

The United State Supreme Court used the language of personal benefits, personal gains, or personal advantage to hold the tipper liable of insider trading and, consequently, the derivative responsibility of the tippee.¹⁶⁸ In determining whether a tippee is under an obligation to disclose or abstain from using nonpublic, material information received from an insider, the Court said it depends on whether the insider himself has breached his Cady, Roberts duty to shareholders in disclosing the nonpublic information to the tippee.¹⁶⁹ Since the insider did not personally benefit, directly or indirectly, from his disclosure, there has been no breach of duty to stockholders and, consequently, there is no tippee derivative breach.¹⁷⁰ Thus, the *Dirks* test is whether the insider personally will benefit, directly or indirectly, from his disclosure.¹⁷¹

4. *Tipping Under Salman v. United States (2016)*

Salman v. United States was the fourth Supreme Court insider trading case after *Chiarella*, *Dirks*, and *O'Hagan*. The Supreme Court endorsed and outlined classical theory of insider trading in *Chiarella*.¹⁷² In *Dirks*, the Supreme Court extended insider trading liability to the tippee and set a test for the personal benefit element.¹⁷³ Finally, in *O'Hagan*, the Court endorsed misappropriation of insider trading.¹⁷⁴

In *Salman v. United States*, the source of information was Maher Kara, a former investment banker at Citigroup.¹⁷⁵ Maher shared inside information with his brother, Michael Kara, who, in turn, shared this information with his friend and relative-by-marriage, Salman.¹⁷⁶ Michael told Salman that the source of information was his brother, Maher.¹⁷⁷ Salman was indicted for federal securities fraud crimes for trading on inside information.¹⁷⁸ Maher testified at Salman's trial that he shared inside information with his brother,

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 667.

¹⁶⁹ *Id.* at 653.

¹⁷⁰ *O'Hagan*, 521 U.S. at 665.

¹⁷¹ 463 U.S. 646 at 664.

¹⁷² *Chiarella*, 445 U.S. 222.

¹⁷³ *Dirks v. SEC*, 463 U.S. 646 (1983).

¹⁷⁴ *O'Hagan*, 521 U.S. at 665.

¹⁷⁵ *Salman*, 137 S. Ct. at 421.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

Michael, to benefit him and expected him to trade on it.¹⁷⁹ Michael testified to sharing that information with Salman, who knew that it was from Maher.¹⁸⁰ The main issue in the *Salman* case is that Maher, the initial tipper, did not receive any pecuniary benefits from his tips as the *Dirks* test requires.¹⁸¹

5. *In Salman v. United States, the Supreme Court Abrogated Second Circuit Ruling*

The Supreme Court in *Salman v. United States* did not follow the minority ruling set by the Second Circuit in *United States v. Newman*,¹⁸² and reaffirmed *Dirks* and rules that Maher breached his duty of trust and confidence to Citigroup and its clients, he was under the duty of trust and confidence of Section 10(b) and Rule 10b-5 and he shall not tip inside corporate information to others who he knows will trade on his tips.¹⁸³ Further, Maher personally benefited by making a gift of inside corporate information to his brother.¹⁸⁴ The facts even stated that Maher asked his brother Michael why he needed the information.¹⁸⁵ Michael answered he owed someone money.¹⁸⁶ The Supreme Court read this as quid pro quo of the gift.¹⁸⁷ Michael substituted money and turned down Maher's money offer, preferring the information.¹⁸⁸ The Court found this a sufficient personal benefit for the tipper, and his advantage was that he was able to give a gift with someone else's property, so the tip saved him money.¹⁸⁹ Further, Salman committed securities fraud by trading on an insider tip in disregard of his knowledge that the tipper's tip violated his fiduciary duty under Section 10(b) and Rule 10b-5.¹⁹⁰

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 422.

¹⁸² In *United States v. Newman*, the Second Circuit held that a "gift" of inside information could not be sufficient to plead insider trading unless there is "proof of a meaningfully close personal relationship" between tipper and tippee that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. See Nicole Vanatko, *The Latest Chapter in Insider Trading Law: Major Circuit Decision Expands Scope of Liability for Trading on a "Tip"*, CONGRESSIONAL RESEARCH SERVICE (2017), <https://fas.org/sgp/crs/misc/LSB10028.pdf>.

¹⁸³ *Salman*, 137 S. Ct. at 421.

¹⁸⁴ *Id.* at 422.

¹⁸⁵ *Id.* at 424.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 425.

¹⁸⁸ *Id.* at 424.

¹⁸⁹ *Id.* at 426.

¹⁹⁰ *Id.* at 428.

The Court also rules that scienter and willfulness from the tipper's side exist when there are beliefs, anticipation, knowledge, or understanding that the tippee will trade based on the inside information.¹⁹¹

6. *Can a Gift Suffice the Personal Gains Test?*

Dirks answered, yes. "The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."¹⁹² *Dirks*' language is extremely specific in determining when it would be proper to convict for insider trading when an insider makes a gift of confidential information. Tippees do not have to receive a monetary or tangible personal benefit, it does not have to be quid pro quo from the tippee to the tipper, but it will be sufficient when the tipper makes a gift to the tippee and, in particular, a relative or friend.¹⁹³ However, the personal benefit element does not include accidentally or unwillingly transferring information and, in this circumstance, the tippee might be liable if the other elements of the violation exist.

Final Thoughts in Understanding Insider Trading and the Legal Justification of Prohibition

The main difference between insider trading liability under classical and misappropriation theory is that:

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.¹⁹⁴

¹⁹¹ *Id.* at 423.

¹⁹² *Dirks*, 463 U.S. 646, 664 (1983). The petitioner lawyer defended this understanding saying these are dictum and the holding is far different and dictum shall not be used to be the basis for criminal liability, the supreme court justice responded on the bench and said "[b]ut it is not a dictum when it says thus the test is whether the insider personally will benefit directly or indirectly from his disclosure." *Id.*

¹⁹³ *Id.*

¹⁹⁴ *O'Hagan*, 521 U.S. at 653.

In other words, “The offense in classical theory is on the person who transacted with the insider, while in misappropriation theory the offense is on the source of the material nonpublic information.”¹⁹⁵

If banning insider trading increases market efficiency and there is a public interest in attaining efficiency of securities markets, it becomes a public interest issue. Protecting that public interest from violation makes the violation a public-order crime, which can be defined as a “crime which involves acts that interfere with the operations of society and the ability of people to function efficiently.”¹⁹⁶ There is no doubt that the stock market nowadays is the backbone of the financial systems of many countries, including the United States. If there is any interference with the soundness of the operation of that market, the entire society will be affected, even for those who did not own securities.¹⁹⁷ Hence, insider trading should be prohibited because it is a public-order crime.

Rule 14e-3 is a specific insider trading rule adopted by the SEC that only applies in the context of tender offer and this paper does not discuss that specific insider trading rule.¹⁹⁸

¹⁹⁵ Donna Nagy, *Securities Regulations Class Spring 2018*, Ind. L. J. (referencing O’Hagan 521 U.S. at 642). “Under the ‘traditional’ or ‘classical theory’ of insider trading liability, a violation of § 10(b) and Rule 10b–5 occurs when a corporate insider trades in his corporation’s securities on the basis of material, confidential information he has obtained by reason of his position. Such trading qualifies as a ‘deceptive device’ because there is a relationship of trust and confidence between the corporation’s shareholders and the insider . . . ‘misappropriation theory’ urged by the [g]overnment here, a corporate ‘outsider’ violates § 10(b) and Rule 10b–5 when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information, rather than to the persons with whom he trades.” *Id.*

¹⁹⁶ Larry J. Siegel, *CRIMINOLOGY: THEORIES, PATTERNS, & TYPOLOGIES*, (9th ed. 2006).

¹⁹⁷ See J. William Hicks, *International Dimensions of U.S. Securities Law* (2018) (“There is a public interest in national property resources so the long-term financial security of its important resources, also has interest in capital availability which secure flow of new capital into private enterprise, and public has interest in economic health . . . 1929 and 1987 market crash proved that there is a relationship between securities market and the nation as a whole.”).

¹⁹⁸ For a detailed analysis for Rule 14e-3, see Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421 (2000).

C. *Criminalization Under Egyptian Capital Market Law, Express Statutory Prohibition Not Defined as Fraud.*

1. *Background on the Egyptian Legal System and its Stock Market:*

Islamic law and Napoleonic Code, which in turn derived its principles from Islamic law,¹⁹⁹ formed the origins of the Egyptian legal system.²⁰⁰ Egypt is a civil law country, which means a court's ruling is built on codes and administrative orders, not on case law as in the United States. However, previous judicial decisions of higher courts do have persuasive authority,²⁰¹ especially when the laws governing the dispute at hand are elastic. The most related securities law in the Egyptian legal system are: Companies Law No. 159 of 1981, the Capital Market Law No. 95 of 1992 and its Executive Regulation, the Law of Non-Banking Financial Markets No. 10 of 2009, Central Depository Law No. 93 of 2000, related executive orders of the chairman of Egyptian Stock Exchange, and related orders of the chairman of Financial Regulatory Authority. Article 27 of Capital Market Law (CML) 95 of 1992 allows for the establishment of Egyptian and foreign securities companies conducting one or more of the following activities:²⁰²

- (1) Underwriting of subscriptions;
- (2) Participation in the establishment of companies issuing securities;
- (3) Venture capital;
- (4) Clearing and settling of securities;
- (5) Forming and managing securities portfolios and mutual funds;
- (6) Acting as brokerage firms;
- (7) Securitization; and
- (8) Direct investment including hedge fund.²⁰³

¹⁹⁹ See *La Civilisation des arabes et l'étude scientifique de l'histoire*, Revue Scientifique, 1er décembre 1883. It says that when Napoleon Bonaparte was in Egypt, he took a book for the Islamic Mālikī school and developed his "Napoleonic Code" on the basis of that Islamic school jurisprudence. *Id.*

²⁰⁰ Ahmed Y. Zohny, *Suitability of US Security Laws and Regulations to Serve as a Model Law for Egyptian Financial Markets*, 15 ARAB L. Q. 5 (2000).

²⁰¹ For more details about Egyptian law, Court System, and government branches see Mohamed S. E. Abdel Wahab, *An Overview of the Egyptian Legal System and Legal Research*, GLOBALEX (2012) <http://www.nyulawglobal.org/globalex/Egypt1.html>. For more details about Egyptian laws affecting economic activity see Radwa S. Elsaman, *Doing Business in Egypt After the January Revolution: Capital Market and Investment Laws*, 11 RICH. J. GLOBAL L. & BUS. 43 (2011), <http://scholarship.richmond.edu/global/vol11/iss1/3>.

²⁰² Law No. 95 of 1992 (Law of Capital Market); *Al-Jarida Al-Rasmiyya Adad 10 mokrer-h*, March 14, 2018 (Egypt).

²⁰³ Added by the order of the Ministry of Investment and International Cooperation no. 113 for 2018, item 4 of the order regulates hedge fund saying, "direct investment company may add up the hedge fund activities to its purposes."

Under Egyptian securities regulations, there are civil, administrative, and criminal sanctions for securities fraud, and several entities are authorized to enforce these sanctions. Law No. 120 for 2008 established “Economic Courts” as a special court to quickly resolve business disputes and to guarantee adjudicating this kind of case through an experienced judge.

To unify the supervisory authority over the entire Egyptian non-banking financial markets, Article 3 of Law No. 10 of 2009 replaced the Capital Market Authority with the Financial Regulatory Authority (FRA)²⁰⁴ to be in charge of enforcing the provisions of CML 95 of 1992. The FRA is an independent surveillance authority over the Egyptian stock market. Under Rule 902(b) of the Securities Act of 1933, Egyptian Exchange (EGX) is an offshore securities market.²⁰⁵

The Capital Markets Law No. 95 of 1992 and its Executive Regulation did not define explicitly what constitutes a security. At this point, Egyptian commercial law or any related law will be applicable to define what constitute securities. Some argue that declining to define securities is a wise and pragmatic approach taken by the Egyptian legislator to expand the coverage of securities for its growing market.²⁰⁶

The Egyptian legislature appeals to the principle of honesty, which is very much drawn from Islamic law and describes activities that are not in conformity with principles of honesty.²⁰⁷

Article 63 of the CML provides a wide anti-fraud provision to criminalize any activities that might affect the integrity and efficiency of the Egyptian stock market. It criminalizes practicing any activity of the capital market without being licensed or going beyond the scope of the license, public offering of any securities in violation of the CML, misstatement or omission of material information either when dealing with government officials or the trading public, and listing securities in stock exchange in violation of stock market regulations.

²⁰⁴ We may also refer to FRA by Egyptian Financial Supervision Authority (EFSA). See *Explanatory*, FIN. REG. AUTHORITY, http://www.fra.gov.eg/content/efsa_en/efsa_pages_en/efsa_clarification_en.htm (last visited Mar. 26, 2020).

²⁰⁵ See Letter from Paul M. Dudek, Chief, Office of Int’l Corp. Fin., to Dr. Sameh El Torgoman, Chairman, Cairo & Alexandria Stock Exchs. (Apr. 16, 2003) (available at <https://www.sec.gov/divisions/corpfin/cf-noaction/cairo041603.htm>).

²⁰⁶ See Zohny, *supra* note 200.

²⁰⁷ *Id.*

Article 17 of the CML stipulated that listed securities must be traded on the stock exchange, and any sale that occurred outside of it would be deemed void.

The Executive Regulation of the CML stipulated that securities transactions on the stock exchange must be executed through a brokerage firm. Article 89 of the CML executive regulation enumerates the conditions that should be satisfied on any broker, which includes a good reputation and never being convicted of a crime that negates his honor or integrity. The executive regulation also established a responsibility for the Egyptian Exchange to oversee its employees and to report any violations to the FSA. Article 90 thereafter explained the brokerage firm duties from the moment it receives the customer's order, prohibited any action that may cause damage to transacted persons, and forbid the execution of transactions for its own account.²⁰⁸

Toward a new financial reform plan, in February 2018, the Egyptian Parliament approved amendments to the CML. The amendments established a legislative framework for the Sukuk market in Egypt, created an exchange for trading in derivatives (including futures, options, and swaps), and expanded the scope of criminal violations under the CML. The Egyptian capital market became more active because of the overall increased attractiveness of investment in Egypt after floating the Egyptian pound in November 2016, and there are many relatively big initial public offerings (IPOs) going on.²⁰⁹ The World Bank report for 2018 referred to positive developments in the Egyptian market. For instance, Egypt strengthened minority investors' protections by increasing corporate transparency, improving one-stop shopping, and making it easier to start a new business.²¹⁰

2. *Statutory Prohibition of Insider Trading Under Egyptian Law*

In comparison to the United States, Egyptian insider trading law has enough of a parity of information prohibition similar to the system in the United States prior to 1980 when the Supreme Court decided *Chiarella*. That means Egyptian law currently adopts the Second Circuit ruling in *SEC v. Texas Gulf Sulphur Co.*²¹¹ that bars any person in possession of material nonpublic information from trading or tipping.

²⁰⁸ Minister of Economics and Foreign Trade Decree No. 135 of 1993 (Executive Regulations of the Capital Market Law), *Al Jarida' al-Rasmiyya*, art. 90 (vol. 81 F. no. 8 1993) (Egypt).

²⁰⁹ Al Tamimi & Company, *Equity Capital Markets in Egypt*, LEXOLOGY (Sept. 4, 2018), <https://www.lexology.com/library/detail.aspx?g=07fb3eaa-db1f-45ac-b050-193888f847a6>.

²¹⁰ WORLD BANK GROUP, *DOING BUSINESS* 17, 19 (16th ed. 2019).

²¹¹ *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d. Cir. 1968). The United States Supreme Court in *Chiarella* refused the Second Circuit ruling and emphasized

Article 64 of the Egyptian CML (translated from Arabic) stipulates that:

Without prejudice to any heavier penalty stipulated in any other law; imprisonment for a term not less than two years and a fine of not less than fifty thousand Egyptian pounds (LE.50,000) or the amount of realized gains or avoided loss and not exceed twenty million (LE. 20,000,000) or the greater of twice the amount of realized gains or the avoided loss, or either penalty shall be inflicted on whomsoever divulges inside information received by virtue of his duties according to the provisions of this law, or benefits whether himself, his spouse, or his children, or inserts material misstatement in his official reports, or disregards any material information, to the extent that it affects the results of such reports, or trade on securities in violation of the provisions of Article No. 20 (*Mokrer*)²¹² of this law.²¹³

In turn, Article No. 20 (*Mokrer*) of the CML added by Law No. 123 for 2008 states

It shall be prohibited for any person who have on his position material nonpublic information which could impact the status of any listed company to trade on its stock before this information became public, and it is also prohibited to tip or disclose this nonpublic information to any person directly or indirectly, the Executive Regulation of this law and stock exchange listing regulations shall determine what constitute a material nonpublic information.²¹⁴

Article 319 of the Executive Regulation defined what might constitute material information, inside information, insiders, and insider trading as follows:²¹⁵

B) Material information: A single piece or set of information that might have actual impact on listed stocks prices, had actual impact on investment decisions of investors, or had an effect on market transactions of stocks.

that there is no express disclose or abstain obligation—it all goes to the fiduciary duty.

²¹² *Mokrer* is an Arabic term that means bis, reiterated, or repeated.

²¹³ Law No. 95 of 1992 (Law of Capital Market), *Al-Jarida Al-Rasmiyya Adad 10 mokrer-h* (2018) (Egypt).

²¹⁴ Law No. 95 of 1992 (Law of Capital Market), *Al-Jarida Al-Rasmiyya Adad 23 mokrer-A* (2008) (Egypt).

²¹⁵ Executive Regulations of Law No. 95 of 1992, added by the minister of Investment order no. 141 for 2006.

Material information becomes public information once it is equally accessible to the trading public, in light of stock exchange disclosing rules.

C) **Inside information:** Any material, nonpublic information about listed companies' activities or one of its related entities.

D) **Insider:** "Any person who has access to information about the company or its issued securities, by virtue of which he can benefit from it himself or through someone else, whether this access to information has been done legally, or illegally, and whether he himself has accessed this information, or it has come to his knowledge through someone else in one way or another, directly or indirectly."²¹⁶ Benefiting from inside information is subject to the crimination of Article (64) of the CML.

H) **Insider trading:** Where any person who has directly or indirectly benefited himself or someone else from trading or using inside information, and the beneficiary of the inside information will be considered or deemed to have benefited from inside information in accordance with the statutory prohibition of Article (64) of the CML.

According to Article 324, "[i]t shall not be considered insider trader whoever trade on securities because of any reason not connected directly or indirectly to the inside information."²¹⁷

3. *Examining Insider Trading Statutory Prohibition Under Egyptian*

Law

The first chapter made it crystal clear that the U.S. system of law defines illegal insider trading as a fraud. However, in Egypt, we have criminal insider trading. It is market abuse. The Egyptian CML explicitly criminalizes insider trading, and the law provides the criminal authority to prosecute insider trading.²¹⁸

In examining the above series of provisions, we will see that Article 64 of the CML sets sanctions for stock market violations that might be committed by governmental officials or any person (permanently or temporarily) hired to provide services for the issuing corporation who, by "virtue of his [or her] duties," knows nonpublic information. The first part of Article 64 prohibited disclosing corporate inside information for any reason

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ What distinguishes fraud-based illegality from criminal prohibition is that in fraud there are elements like a material non-disclosure in the face of an affirmative duty to disclose and reliance. In criminal prohibition, the law explicitly prohibits and defines the prosecution authority.

and not just for trading purposes, as if the disclosure made to benefit the issuer's competitive in a certain market. However, the last sentence of Article 64 says "or traded on securities in violation of the provisions of Article No. 20 (*Mokrer*) of this law." This part of the prohibition of insider trading might not encompass all insider trading violations because the language suggests that it is meant to address stock exchange officials, Financial Regulatory Authority, rating companies, or any person empowered by stock market law to have access to a corporation's nonpublic information. In other words, Article 64 proposes to incriminate officials and temporary insiders for insider trading. Yet, it does not expressly prohibit insider trading that might be committed by any person who is not a government official nor a permanent or temporary insider.

So, the question is, would someone like *Chiarella* or *O'Hagan* that is not an insider of the company whose securities had been traded on basis of nonpublic information, would they fall within article 64? It seems no because they were hired to provide services for the issuing corporation. In *O'Hagan* Case Pillsbury was the issuing corporation but *O'Hagan* law firm worked for Grand Metropolitan. In application to the Egyptian law, *O'Hagan* would not be covered under Article 64 of the Egyptian CML executive regulation, but he would be liable under Article 20 which seems broader.

This gap in legislation might be filled by Article No. 20 (*Mokrer*) of the CML in its use of the term "any person." However, this language does not properly address the offense of insider trading because the legislature improperly inserted terms to define materiality of information and to show causation of prohibition. The article specifically identifies "any person who has a material nonpublic information which could impact the status of any listed company to trade on its stock before this information became public" Using the phrase "impact the status of any listed company" suggests that the cause of prohibition is not to disadvantage the listed corporation. That might be interpreted to mean that if the corporation is not itself injured, insider trading is not prohibited. However, Article No. 20 (*Mokrer*) clearly prohibited tipping inside information and also made a reference to the Executive Regulation of the CML to define materiality of information.

4. *Prohibition of Insider Trading on the Executive Regulation of the*

CML

Article 319 of the Executive Regulation of the CML adequately addressed insider trading; it is a broad parity of information rule.²¹⁹ The language directly defined what might constitute material information by

²¹⁹ This paper did not address the constitutionality of the legislation mechanism of promulgating executive regulation which adds criminalization to the CML through a ministerial decree.

connecting it to an objective test: when the information has an actual impact on the stock's prices. Article 319 in item (D) had broad disclosure or abstain rules and expresses prohibition the same as pre-*Chiarella*. Item (D) adequately defined who is an insider and did not restrict its scope for corporate fiduciaries or government officials. Instead, it used the term "any person" to allow insider trading prohibitions to apply to any person who came into possession of inside information, disregarding the legality of the source of the information, and subjected the violator to Article 64 of the sanction.

Article 319 of the Executive Regulation in item (E) clearly defined insider trading and its scope. The language includes those who benefit themselves or someone else from trading on the basis of material, nonpublic information. Benefits do not have to be pecuniary personal benefits. They could be other personal benefits, direct or indirect, whether for oneself or someone else. This means Egyptian insider trading regulation does not have the *Dirks v. SEC* and *Salman v. United States* personal benefit issue. Item (E) even established a presumption to satisfy the personal benefit test by saying that benefiting someone else without any personal direct or indirect benefits would be sufficient to charge someone with insider trading under Article (64) of the CML.

The Executive Regulation of the CML in Article 324 guaranteed the disclaimer right for any person charged with insider trading to negate culpability if the reason for his or her transaction was for other reasons and not on the basis of insider trading. This article ruling exactly resembles the Rule 10b-5-1 "knowing possession" requirement in American law.²²⁰

5. *Insider trading prohibition for portfolio management and brokerage companies*

The Executive Regulation of the CML in chapter six determined the obligations of portfolio management and brokerage companies towards their clients, which include obligations of:

Article 214 stipulated that the company in execution of its licensed activities shall adhere to the principles of honesty, justice, equity, and due diligence.²²¹

²²⁰See Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, ARTICLES BY MAURER FAC. 1129 (1999).

²²¹ Law No. 95 of 1992 (Law of Capital Market), *Al-Jarida Al-Rasmiyya Adad 10 mokrer-h*, March 14, 2018 (Egypt),

Article 231 prohibited portfolio management or brokerage companies from selective disclosure and any direct or indirect discriminatory disclosure between their clients.²²²

Article 244 of section five of chapter six of the executive regulation expressly prohibited insider trading. It states:

Neither the owner of the portfolio management or brokerage companies nor any of its directors or employees shall transact on securities on basis of a secret information that is not publicly disclosed for the market or accessible for the trading public, even if this information or data was incomplete or was about a forthcoming transaction on these securities or any material action might affect the securities, its issuer or its prices.²²³

This article prohibits owners, directors, and employees of a portfolio management company or brokerage companies from transacting on any securities on the basis of nonpublic information.

However, Article 244 express prohibition came under chapter six of the Executive Regulation of the CML.²²⁴ This chapter only regulates companies established either to provide portfolio management or brokerage services.²²⁵ It only prevents owners, directors, and employees (the “insiders”) of these two types of companies from trading on securities on the basis of nonpublic information received by virtue of their role in these businesses. Yet, this prohibition does not completely address insider trading cases, as if one of the three insiders mentioned did not trade or transact but tipped inside information in related to securities transactions.

Hence, the insider trading prohibition of Article 244 of Executive Regulation of CLM is not a comprehensive criminalization of insider trading that might be committed by owners, directors, and employees of companies that provide portfolio management and brokerage services. At this point, the general provisions of insider trading might be applicable to fill the gap of chapter six as in the second example below.

6. *Egyptian court’s insider trading ruling*

The Egyptian Criminal Courts fill gaps where the insider trading laws fall short. Cairo Criminal Misdemeanors Court convicted the regional manager of American Express Bank in Cairo for insider trading because he traded based

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

on material, nonpublic information for personal benefit.²²⁶ The facts say that an Egyptian-American Bank planned to sell a large number of its outstanding shares, and the American Express regional manager knew about this plan because they owned 40% of the outstanding shares of Egyptian American Bank (the issuer).²²⁷ The regional manager received this information by virtue of his job at American Express.²²⁸ Therefore, he was an insider according to Article (64) of the CML and should not have traded based on this inside information.²²⁹

Also, the Cairo criminal court for financial crimes convicted the chairman and managing director of a brokerage firm under Articles 64 and 68²³⁰ of the CML because he disclosed nonpublic information about the stock trading sessions, which came to his knowledge by virtue of his role at the brokerage firm. The Egyptian State Council affirmed this ruling on appeal and ruled to discharge the defendant from his chair at the brokerage firm for lack of honesty and trust, which is a required character trait to be a key employee in a company.²³¹

III. ENFORCEMENT AND CHARGING FOR INSIDER TRADING

A. *Securities and Exchange Commission in the American Legal System*

1. *Securities enforcement law*

In the United States, the enforcement of securities regulations takes at least five forms: (1) Private litigation through courts or by arbitration where the plaintiff petitions for damages, contract rescission and/or equitable relief; (2) SEC enforcement action in administrative proceedings; (3) SEC enforcement action in judicial proceedings; (4) Criminal action by the United States Department of Justice (DOJ) in federal courts; and (5) Self Regulated Organization (SRO)²³² action to sanction its members for violations of its

²²⁶ Cairo Criminal Misdemeanors Court, financial circuit, case no. 400 for 2005 ordered January 31, 2005.

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ Cairo Criminal Misdemeanors Court, financial circuit, case no. 400 for 2005 ordered January 31, 2005; Law No. 95 of 1992 (Law of Capital Market), *supra* note 221.

²³⁰ *Id.* The actual manager of the company shall be liable to the penalties specified in the provisions of this Law for violations committed. *Id.* The company assets shall, in all cases, warrant the payment of the fines. *Id.*

²³¹ Cairo Financial Criminal Court, financial misdemeanors circuit, case no. 976 for 2004.

²³² See Troy Segal, *How Does FINRA Differ from the SEC?*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/how-does-finra-differ-sec/> (updated on Apr. 23, 2018). FINRA is the largest SRO in the securities industry in the United

rules.²³³ The DOJ is the only prosecuting authority for securities criminal violations through the United States Attorney’s Office.²³⁴ The DOJ often initiates its securities criminal investigations and prosecutions through SEC referrals.²³⁵ The SEC derives its investigation powers from sections 20(a) and 8(e) of the Securities Act, sections 21(a)(1)²³⁶ and (2) of the Exchange Act, section 209(a) of the Advisers Act, and Investment Company Act section 42(a).²³⁷ These provisions and federal court rulings give the SEC the authority, in its discretion, to develop an investigation of particular activities.²³⁸ During its preliminary investigation, SEC staff may identify certain corporate personnel or officers to interview or to present certain information, and knowingly and willfully providing false information is a crime.²³⁹ The Supreme Court held in *Securities & Exchange Commission v. Jerry T. O'Brien*²⁴⁰ that the SEC decisions from informal investigation, formal investigation, bringing a case, or making settlements are considered “administrative investigations” and its findings are not binding.²⁴¹

2. Inside the SEC

In the wake of the stock market crash in 1929, Congress held hearings to investigate related securities regulations to identify the reasons for the problem and to address them adequately. Based on these hearings, Congress passed the Securities Act of 1933 and the Exchange Act of 1934 as federal

States and is a not-for-profit entity. *Id.* An SRO is a membership-based organization that creates and enforces rules for members based on federal laws. *See id.*

²³³ See J. William Hicks, INTERNATIONAL DIMENSIONS OF U.S. SECURITIES LAW (2018).

²³⁴ U.S. Dep’t. of Justice, 9-27.000 - PRINCIPLES OF FEDERAL PROSECUTION, <https://www.justice.gov/jm/jm-9-27000-principles-federal-prosecution> (last updated Feb. 2018).

²³⁵ *Id.*

²³⁶ U.S. Securities Exchange Act of 1934 § 21(a)(1), 15 U.S.C. § 78u(a)(1) (2018). “The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter . . . The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions. . . .” *Id.*

²³⁷ Securities Act of 1933, 15 U.S.C. §§ 77h(e), 77t(a) (2018); Security Exchange Act of 1934, 15 U.S.C. § 78u(a)(1) (2018); Investment Advisers Act of 1940, 15 U.S.C. § 80b-9(a) (2018); Investment Company Act of 1940, 15 U.S.C. § 80a-41(a) (2018).

²³⁸ *Id.*

²³⁹ Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Consideration for when the Agency Comes Calling*, 51 ADMIN. L. REV. 1143 (1999).

²⁴⁰ *Sec. & Exch. Comm’n v. Jerry T. O’Brien, Inc.*, 467 U.S. 735, 742 (1984).

²⁴¹ *Id.*

legislation to govern the secondary market of securities.²⁴² The Exchange Act created the Securities and Exchange Commission to enforce the newly passed securities law with the main responsibility of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.²⁴³

The SEC oversees the key participants in the securities market, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. The SEC uses its enforcement authority to protect the stock market from securities violations, especially securities fraud.

The SEC still faces some challenges to meet its responsibilities concerning the stock market. The U.S. securities market is incredibly active,²⁴⁴ and unlawful trading strategies are becoming more complex and are difficult to identify, as identification requires analysis of large datasets. That challenge requires even more resources to meet the increasing caseload, and a mass of digital information needs advanced technology to penetrate this changing landscape.²⁴⁵ Insider trading cases expose not just the advanced technical means by which violators obtain secret information, but the lengths and hard paths they take to avoid being caught.²⁴⁶ That, in turn, stretches the SEC enforcement scope responsibility into newer areas. The SEC enforcement actions included actions against IT professionals, hackers who misappropriate corporate data, and providers of political intelligence.²⁴⁷ The SEC prosecutes civil enforcement suits in federal courts and initial administrative proceedings within the SEC against any person or entities who violate the securities law.

²⁴⁸

²⁴² 15 U.S. Code § 77a; 15 U.S. Code § 78a.

²⁴³ See *What We Do*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/Article/whatwedo.html> (last visited on Mar. 25, 2020). The responsibility of the Commission is to:

1. interpret and enforce federal securities laws;
2. issue new rules and amend existing rules;
3. oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies;
4. oversee private regulatory organizations in the securities, accounting, and auditing fields; and
5. coordinate U.S. securities regulation with federal, state, and foreign authorities.

²⁴⁴ See *US Trading Volume By Quarter*, ITG, <https://www.itg.com/trading-volume/quarter/>. The number of trading shares of the U.S. stock market is over 130 Million share per day. *Id.*

²⁴⁵ See NAGY ET AL., *supra* note **Error! Bookmark not defined.**, at 685.

²⁴⁶ See Marc Fagel & Elizabeth Dooley, *The Unrelenting Pace of SEC Insider Trading Actions*, GLOBAL INVESTIGATIONS REV. (Nov. 2, 2017), <https://globalinvestigationsreview.com/article/1149624/the-unrelenting-pace-of-sec-insider-trading-actions>.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

In 1984 Congress began to sharpen the SEC insider trading remedies. Before 1984 the SEC could only seek an injunction, order disgorgement of profits or refer the violator to the Justice Department to proceed with a criminal prosecution.²⁴⁹ Congress amended the Securities Exchange Act to add another penalty that the SEC can execute against insider trading violations.²⁵⁰ The amended Securities Exchange Act authorizes the SEC to seek a civil penalty of up to three times the amount of profits made or losses avoided by Rule 10b-5 or 14e-3 violator in addition to any criminal fine ordered.²⁵¹

In Fiscal Year 2017, the SEC brought 754 actions and won judgments and orders of amount more than \$3.7 billion in disgorgement and penalties.²⁵² Further, the SEC returned \$1.07 billion to harmed investors, suspended securities of 309 companies, and barred or suspended 625 individuals.²⁵³

2.1. *Insider Trading and Securities Fraud Enforcement Act of 1988 and
The Insider Trading Sanctions Act of 1984*

Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") to combat the increased insider trading misconduct in the mid-1980s.²⁵⁴ The ITSFEA language reflects a strong desire to deter and to sharpen the SEC enforcement weapons against insider trading.²⁵⁵ The main provisions of ITSFEA includes the following:

1. ITSFEA Section 21A (a) (3) which submitted the person controlling an insider trading violation for a civil monetary penalty if the controlling person knows or recklessly disregarded the controlled person insider trade offense.²⁵⁶

²⁴⁹ JAMES COX, ROBERT HILLMAN & DONALD LANGEVOORT, SECURITIES REGULATIONS CASES AND MATERIALS 941 (7th ed. 2013).

²⁵⁰ Congress's policy of expanding the SEC enforcement tools reached all other securities laws violations, the enforcement remedies and Penny Stock Reform Act of 1990 expanded the sanctions available to empower the SEC with civil penalties and administrative cease-and-desist orders besides its disciplinary authority over market professionals. *Id.*

²⁵¹ *Id.*

²⁵² *Annual Report A Look Back At Fiscal Year 2017*, U.S. SEC. AND EXCH. COMM'N DIV. OF ENF'T (last visited Mar. 23, 2020), <https://www.sec.gov/files/enforcement-annual-report-2017.pdf>.

²⁵³ *Id.* at 3.

²⁵⁴ Stephen J. Choi & Adam C. Pritchard, SECURITIES REGULATION CASES AND ANALYSIS 381(4th ed. 2015).

²⁵⁵ *Id.*

²⁵⁶ *Id.*

2. The ITSFEA embolden any person knows about insider trading violation to tip the SEC in exchange of up to 10% for the penalty collected.²⁵⁷
3. The ITSFEA confirmed the validity of the SEC insider trading tender offer Rule 14e-3. Before ITSFEA commentators challenged the validity of Rule 14e-3 questioning at what point the tender offer actually exist to arise the cause of action for pre-offer activities under Rule 14e-3.²⁵⁸ Further, does Rule 14e-3 survive the Supreme Court ruling in *Chiarella*, which requires the pre-existence of a fiduciary duty to disclose? Federal Courts rebutted the first challenge and determined the scope of insider trading tender offer Rule 14e-3 to include activities that follow the moment the target board consider the tender offer proposal.²⁵⁹ Regarding the second challenge, ITSFEA reflects Congress's intent in granting the SEC more powerful authority to combat and define fraud in Rule 14e-3. The ITSFEA grants the SEC the authority to define what constitutes fraudulent conduct and to adopt within its own discretion the reasonable means to stop such fraudulent practices.²⁶⁰

2.2. Injunctions.

The enforcement of the securities laws often requires permanent injunctions against violators to prevent future violations.²⁶¹ Many provisions like section 21 (A) of the Exchange Act, Section 20(b) of the Securities Act, and Section 42 (d) of the Investment Company Act gives the SEC the authority to seek a permanent or temporary injunction remedy against any person engaged or about to engage in practices that constitute a violation of the Exchange Act or other related securities law.²⁶² Even though the issuance of injunctions might seem “mild prophylactic,” its effect could be severe because the SEC could build the injunction on “likelihood” grounds and past violations, not actual new facts.²⁶³ The SEC often pray for relief in addition to the injunction remedy, the SEC tailored the relief to be inconvenient to the violation and violator circumstances. These remedies could take the form of

²⁵⁷ *Id.*

²⁵⁸ Howard M. Friedman, *The Insider Trading and Sec. Fraud Enft Act of 1988*, 68 N.C. L. Rev. 465 (1990), <http://scholarship.law.unc.edu/nclr/vol68/iss3/2>.

²⁵⁹ *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.* 529 F. Supp. 1179, 1192, 1193 (S.D.N.Y. 1981). *See also* Friedman, *supra* note **Error! Bookmark not defined.**

²⁶⁰ Friedman, *supra* note **Error! Bookmark not defined.**

²⁶¹ Marc I. Steinberg, *SEC and Other Permanent Injunctions-Standards for Their Imposition Modification and Dissolution*, 66 CORNELL L. REV. 27 (1980).

²⁶² COX ET. AL., *supra* note 249.

²⁶³ *Id.*

disgorgement of the ill-gotten profits,²⁶⁴ securities sale rescission, appointment of a special counsel to carry out an inside investigation about the corporation and its management, or to appoint an independent manager to the violated company.²⁶⁵

3. *SEC Divisions*

The SEC functions through five Divisions and twenty-three Offices.²⁶⁶ The Commission's staff are located in Washington and in eleven Regional Offices throughout the country.²⁶⁷ These Divisions are:²⁶⁸

1. **Division of Corporation Finance:** Oversee corporate disclosure of continuing and diperiodic information to the investing public.
2. **Division of Trading and Markets:** Enforce the SEC responsibility for maintaining fair, orderly, and efficient markets.
3. **Division of Investment Management:** Protect and promote investors interest on capital formation through oversight and regulation of America's \$66.8 trillion investment management industry.
4. **Division of Enforcement:** Prosecuting division that investigates securities violations and recommends commencement of civil actions in federal court or as administrative proceedings before an administrative law judge. The staff of this division is composed of 1,452 attorneys, accountants, analysts and other professionals.²⁶⁹
5. **Division of Economic and Risk Analysis:** Its main responsibility is to integrate robust economic analysis and rigorous data analytics into the work of the SEC. Further, to educate and support investors to function efficient markets by providing vital support in the form of

²⁶⁴ Disgorgement is not a penalty but is a kind of sanctions meant to prevent unjust enrichment, yet when the amount of disgorgement exceeds the ill-gotten gains deemed a penalty. *See id.*

²⁶⁵ *Id.* One of the SEC enforcement tools “Obey the Law” injunction orders, the SEC utilize this mechanism to issue broad obey the securities law request, so any future violation will give rise to an enforcement action.

²⁶⁶ Offices: Office of the General Counsel, Office of the Chief Accountant, Office of Compliance Inspections and Examinations, Office of Credit Ratings, Office of International Affairs, Office of Investor Education and Advocacy, Office of Municipal Securities, Office of Ethics Counsel, Office of the Investor Advocate, Office of Women and Minority Inclusion, Office of the Chief Operating Officer, EDGAR Business Office, Office of Acquisitions, Office of Financial Management, Office of Support Operations, Office of Human Resources, Office of Information Technology, Office of Legislative and Intergovernmental Affairs, Office of Public Affairs, Office of the Secretary, Office of Equal Employment Opportunity, Office of the Inspector General, Office of Administrative Law Judges.

¹⁵⁰ SEC, <https://www.sec.gov/>.

²⁶⁸ *Id.*

²⁶⁹ *See Congressional Budget Justification FY 2017*, U.S. SECURITIES AND EXCHANGE COMMISSION at 16 (2017), <https://www.sec.gov/about/reports/secfy17congbudjust.pdf>.

economic analyses through its website which includes EDGAR database. Further, the division staff provide the economic analysis and research, risk assessment, and data analytics.²⁷⁰

4. *The SEC Investigatory Process:*

The SEC insider trading enforcement process is divided into four main phases: “detection, preliminary investigation, formal investigation, and prosecution.”²⁷¹ The reason for empowering the SEC by enforcement authority is that numerous regulatory provisions of the securities laws create problems that might prevent a meaningful pursuit of violations by private plaintiffs.²⁷² This is because of the nature of the regulations, which focus not on investor protection as such, but rather in achieving desired efficiency and general confidence in the market.²⁷³

5.1. *The SEC Detection, Preliminary Investigation, and Formal Investigation*

According to the Division of Enforcement’s Enforcement Manual, processing a securities fraud investigation includes certain procedures, including the following:²⁷⁴

The public can complain or tip the SEC through SEC’s online website²⁷⁵ or by contacting any of the SEC’s offices. After assessing the reliability of the tip, the complaint or the referral the staff processes it according to the SEC manual.²⁷⁶ The Dodd-Frank Wall Street Reform and Consumer Protection Act established a Whistleblower Award Program for any person who provides information that results in monetary sanctions of over \$1 million on a successful enforcement action, which awards a person 10-30% of the total monetary sanctions.²⁷⁷

²⁷⁰ *Id.*

²⁷¹ Andrew P. Van Osselaer, *Insider Trading Enforcement & Link Prediction*, 96 TEX. L. REV. 399, 402 (2017).

²⁷² James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L. J. 737, 74344 (2003).

²⁷³ *Id.*

²⁷⁴ SEC, DIVISION OF ENFORCEMENT, ENFORCEMENT MANUAL (2017), <https://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

²⁷⁵ SEC CENTER FOR COMPLAINTS AND ENFORCEMENT TIPS, <http://www.sec.gov/complaint.shtml>.

²⁷⁶ See SEC ENFORCEMENT MANUAL, *supra* note 274, at 12.

²⁷⁷ See 15 U.S.C. § 78u-6.

The SEC Division of Enforcement, in ranking its investigations policies, devotes more resources to investigate cases deemed “National Priority Matters.”²⁷⁸ In order to classify an investigation as a National Priority Matter, they consider some criteria such as (1) deterrence for a potentially widespread misconduct; (2) the position occupied by the violator; (3) whether there is a violation of newly-enacted legislation; (4) the riskiness of the misconduct for investors or important sector of the market; and (5) whether the matter affects a significant number of potential or vulnerable victims.²⁷⁹

Based on those criteria and the type of violation, the Division of Enforcement handles some referrals with great care as if the case is related to Bank Secrecy or the Public Company Accounting Oversight Board.²⁸⁰

After receiving a tip or a referral, a staff member searches—in light of the Division procedures and the Assistant Director’s guidance—the potentiality of executing a successful enforcement case.²⁸¹ If the staff reaches a positive possibility of successful investigation, she signs into a Hub system and recommends opening a Matters Under Inquiry (MUI) and also suggests the office that should process the MUI for the sake of achieving the best use of the resources of the Division.²⁸² The MUI is then either closed or converted to an investigation, and the staff in consultation with the Associate Director or the Unit Chief will determine the fate of the MUI.²⁸³ If it is turned into an investigation, securities law authorizes the SEC and its officers to issue subpoenas for a witness to present a document or to take a testimony under oath.²⁸⁴ In some urgent cases, the Commission delegates to one of the staff members to act on their own discretion on the Commission’s behalf as a Duty Officer.²⁸⁵

The SEC in administrative proceedings can bar a person from association with a broker-dealer or investment adviser if there was a civil or criminal conviction against him.²⁸⁶ The SEC encourages its staff to close an investigation when it becomes apparent that no further steps can be taken.²⁸⁷ The staff member should consider the seriousness of violations, resources available for investigation, the strength of the evidence, who will be harmed if he decides to close, and the age of the violation when he decides the proper

²⁷⁸ SECURITIES AND EXCHANGE COMMISSION DIVISION OF ENFORCEMENT: Enforcement Manual 8 (2017).

²⁷⁹ *Id.*

²⁸⁰ *Id.* at 9.

²⁸¹ *Id.* at 8.

²⁸² *Id.* at 12.

²⁸³ *Id.*

²⁸⁴ *Id.*

²⁸⁵ *Id.*

²⁸⁶ *Id.* at 25.

²⁸⁷ *Id.* at 26.

proceeding of the investigation.²⁸⁸ Closing an investigation will be followed by termination notices to be sent to every person who was involved in the investigation.²⁸⁹ Successful enforcement action cannot be closed unless all enforcement is completed either by a final judgment or Commission order and after paying the monetary relief in full.²⁹⁰

The SEC, under certain considerations, may continue its own investigations even if there is ongoing SEC litigation. This investigation requires an independent good-faith basis as if there is a possibility to add to the litigation additional violators.²⁹¹ The SEC adopts a clear policy in its dealing with the press and how to ask for production of documents or information. SEC staff must begin with informal channels first to obtain the information or the documents in hands of the media member entity.²⁹² If the negotiations do not succeed, an assessment will be taken before seeking issuance of a subpoena.²⁹³

When an SEC staff contacts any individual for an investigation, she must, and before asking any substantive questions, make certain disclosures under the Privacy Act, 5 U.S.C. § 552a. For example, she must declare that even if the laws authorize the SEC to ask for information, a witness is not required to cooperate and there is no direct effect upon her for refusing to disclose information she might have disclosed. Further, SEC Rule 7 (b) allows any person who appears in person at a formal investigation to be accompanied, represented and advised by counsel.

The SEC Memoranda of Understanding (MOU), Mutual Legal Assistance Treaties (MLATs) (used for Criminal Matters), ad hoc, and voluntary cooperation are the channels available to the SEC to contact a foreign witness residing in another country. SEC's Office of International Affairs will review and guide the staff members work to request information from a foreign person without violating other countries laws.

5.2 SEC Detection Mechanism

The SEC has taken an aggressive stance against insider traders, unrelenting against those who abuse nonpublic information and made it a clear "No Place to Hide."²⁹⁴ Insider trading typically comprises approximately 10%

²⁸⁸ *Id.*

²⁸⁹ *Id.* at 27.

²⁹⁰ *Id.*

²⁹¹ *Id.* at 32.

²⁹² *Id.*

²⁹³ *Id.* at 40.

²⁹⁴ Van Osselaer, *supra* note 271; statement of Former SEC Chair Mary Jo White.

of the SEC caseload.²⁹⁵ The SEC's tech-policy utilizes the fact that in a wired globe, people are more closely connected than we imagine.²⁹⁶ The SEC's tech-enforcement procedures are based on development of in-house, automated, market-data-analysis systems. These systems are able to detect suspicious trades and therefore reduce the Commission's reliance on outside tips.²⁹⁷ The SEC uses software techniques like link prediction, data synthesis, and algorithms to trace the connection between two points on a network using breadth-first bilateral analysis.²⁹⁸

The Commission adopted Rule 613 Consolidated Audit Trail (CAT) to create a comprehensive consolidated audit trail which allows regulators to accurately track all activity throughout the U.S. markets in National Market System (NMS) securities.²⁹⁹ The CAT compiles every trade order, execution, or cancellation process to be pulled from national stock exchanges and FINRA databases, and by using the algorithmic detection systems on all national-market trading data, the CAT system enables SEC to be everywhere at once.³⁰⁰

The SEC Market Abuse Unit depends on three market-analysis programs: (1) ARTEMIS, which is built to detect suspicious trading patterns among traders; (2) ABAP, which is designed to analyze specific transactions in order to detect suspicious trading before market-moving causes and shows the coordinated transactions; and (3) NEAT, which is designed to allow enforcement investigators rapid access to transactions from a massive index.³⁰¹

²⁹⁵ Marc Fagel & Elizabeth Dooley, *The Unrelenting Pace of SEC Insider Trading Actions*, GLOBAL INVESTIGATIONS REVIEW (2017), <https://globalinvestigationsreview.com/article/1149624/the-unrelenting-pace-of-sec-insider-trading-actions>.

²⁹⁶ Van Osselaer, *supra* note 271, at 412 (citing Andrew Guthrie Ferguson, *Big Data and Predictive Reasonable Suspicion*, 163 U. PA. L. REV. 327, 354 (2015)). This study says among Facebook users, the "average number of acquaintances separating any two people in the world was not six [as is often said colloquially] but 4.74". *Id.*

²⁹⁷ *Id.* at 399.

²⁹⁸ *Id.* at 407. The author refers to an article that discusses the Graph traversal technique. See Prateek Garg, *Breadth First Search*, HACKEREARTH, <https://www.hackerearth.com/practice/algorithms/graphs/breadth-first-search/tutorial/>.

²⁹⁹ U.S. Sec. Exch. Comm'n, *Rule 613 (Consolidated Audit Trail)*, <https://www.sec.gov/divisions/marketreg/rule613-info.htm> (last updated Feb. 24, 2020).

³⁰⁰ Osselaer, *supra* note 271, at 406.

³⁰¹ Mary Jo White, Chair, U.S. Sec. Exch. Comm'n, Opening Remarks at the 21st Annual International Institute for Securities Enforcement and Market Oversight (Nov. 2, 2015), <https://www.sec.gov/news/statement/remarks-21st-international-institute-for-securities-enforcement.html>.

6. *Cross-border insider trading*

The globalization of securities markets and the rapid increase in the number of cross-border mergers and acquisitions has created the environment where the largest insider trading violations are committed.³⁰² A securities violation committed while trading shares of a foreign company listed in the U.S. abuses both the domestic and U.S. market mechanisms.³⁰³

Under some circumstances, foreign investors prefer to litigate their securities disputes in the United States because of some practical advantages which include: (1) the possibility of their action being brought in the form of class action; (2) the possibility of a well-compensating jury verdict; (3) generous discovery under the Federal Rules of Civil Procedure; and (4) the possibility of obtaining legal assistance on the basis of a contingent attorney's fee and the absence of a loser-pays rule.³⁰⁴

There is no certain SEC policy on when U.S. insider trading rules will be extraterritorially applicable, but based on SEC enforcement actions, "it is that the trading site—the use of U.S. market mechanisms—that counts most."³⁰⁵ The SEC defines "foreign issuer" broadly to include: foreign issuer "foreign government", supranational entities, foreign private issuers—essentially U.S. issuers who do not qualify as a foreign private issuer, and certain Canadian private issuers.³⁰⁶ A foreign issuer might be subject to the U.S. Securities Act of 1934 either because of the size of issued securities or because of his free will.³⁰⁷

In the 1960s, the increase of international stock markets infused the enforcement of the American federal domestic regulations.³⁰⁸ American lower courts, in order to decide their jurisdiction over securities fraud cases that include a foreign element, adopted some principles based on where the fraudulent conduct occurred—"the conduct test"—and the nationality of the injured investor or issuer—"the effects test."³⁰⁹ This custom of adjudicating

³⁰² Donald C. Langevoort, *Cross-Border Insider Trading*, 19 DICK. J. INT'L L. 161 (2000).

³⁰³ *Id.* at 162.

³⁰⁴ MODEL RULES OF PROF'L CONDUCT r. 1.5 (AM. BAR ASS'N 1980).

³⁰⁵ Langevoort, *supra* note 302.

³⁰⁶ 17 C.F.R. § 240.3b-4 (1967). (Providing a definition of "foreign government," "foreign issuer" and "foreign private issuer").

³⁰⁷ *Id.*

³⁰⁸ Nagy, Painter & Sachs, *supra* note **Error! Bookmark not defined.**, at 985.

³⁰⁹ Staff of the U.S. Sec. Exch. Comm'n, *Study of the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934*, U.S. SEC. EXCH. COMM'N (2012), <https://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf>. See Donald C. Langevoort, *Schoenbaum Revisited: Limiting the Scope of Antifraud*

the jurisdiction over these kind of cases lasted until 2010 when the Supreme Court decided *Morrison v. National Australia Bank Ltd.*³¹⁰

7. *Morrison v. National Australia Bank Ltd.*³¹¹

In this case, the United States Supreme Court decided “whether § 10(b) of the Securities Exchange Act of 1934 provides a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.”³¹²

The Supreme Court ruled that Section 10(b) does not provide a cause of action to a foreign plaintiff suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.³¹³ The Court stated,

[W]hen a statute gives no clear indication of an extraterritorial application, it has none. It is a longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States. If § 10(b) is not extraterritorial, neither is Rule 10b–5. On its face, § 10(b) contains nothing to suggest that it applies abroad.³¹⁴

Protection in an Internationalized Securities Marketplace, 55 L. AND CONTEMP. PROBS. 241 (1992). At that time Langevoort, argued that “the forces creating an internationalized securities marketplace, the prevailing extraterritoriality doctrine has become both useless and problematic.” *Id.* at 242.

³¹⁰ *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010).

³¹¹ *Id.*

³¹² *Id.* at 250. The respondent in the case was National Australia Bank (National), an Australian Bank whose shares were not traded on any stock exchange in the United States. National purchased HomeSide Lending, an American mortgage-servicing company headquartered in Florida. When National wrote down in its books the value of HomeSide’s assets, National’s share prices fell. The petitioner is an Australian shareholder of National that sued National, HomeSide, and officers of both companies for loss the shareholder suffered because of the write-downs of HomeSide’s assets. He claimed that the defendants violated §10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b–5. He claimed that “HomeSide and its officers had manipulated financial models to make the company’s mortgage-servicing rights appear more valuable than they really were; and that National and its chief executive officer were aware of this deception.” *Id.* at 247252.

³¹³ *Id.*

³¹⁴ *Id.* at 247. The court ruled that saying there is a domestic activity in the United States where HomeSide executives engaged in the alleged deceptive conduct and that shall trigger the U.S. subject matter jurisdiction is rebuttable by the fact that “the Exchange Act’s focus is not on the place where the deception originated, but on purchases and sales of securities in the United States. Section 10(b) applies only to

Further, the Court rejected the notion that the Exchange Act provisions include conduct that occurred in the United States and affected exchanges or transactions abroad.³¹⁵ The Court found that if Congress intended such foreign application, “it would have addressed the subject of conflicts with foreign laws and procedures.”³¹⁶ Hence, in *Morrison*, the Court sought to limit the extraterritorial reach of antifraud provisions in U.S. securities laws. Since then, the Court has scaled down the exposure of foreign issuers to securities liability risk, particularly in class-action litigation.³¹⁷

One month after the Supreme Court’s ruling in *Morrison*, President Obama signed the Dodd-Frank Act of 2010 into law.³¹⁸ The Dodd-Frank Act amended the jurisdictional provision of § 22 of the Securities Act and § 27 of the Exchange Act to resuscitate the old jurisdiction conduct and effect tests.³¹⁹ The effect test considers “whether the wrongful conduct had a substantial effect in the United States or upon United States citizens” while the conduct test considers “whether the wrongful conduct occurred in the United States.”³²⁰ In March 2017, in *SEC v. Traffic Monsoon, LLC*,³²¹ the District of Utah ruled that the plain language of the Dodd-Frank Act’s amendments did not expressly overturn the Supreme Court’s ruling in *Morrison*.³²² Further, the court found that Congress clearly intended to authorize the SEC and DOJ to sue on the bases of conduct or effects within the United States, regardless of where the

transactions in securities listed on domestic exchanges and domestic transactions in other securities.” *Id.* at 249.

³¹⁵ *Id.* at 273.

³¹⁶ *Id.* at 269.

³¹⁷ Yuliya Guseva, *The SEC and Foreign Private Issuers: A Path to Optimal Public Enforcement*, 59 B.C.L. REV. 2055 (2018).

³¹⁸ See 15 U.S.C. § 78u-6.

³¹⁹ Section 929P(b) of the Dodd-Frank Act, which amended § 22 of the Securities Act and § 27 of the Exchange Act added the following language:

The district courts of the United States and the United States court of any territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or by the United States alleging a violation of [either Section 10(b) of the Securities Exchange Act or Section 17(a) of the Securities Act] involving: (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

Nagy, Painter, & Sachs, *supra* note **Error! Bookmark not defined.**, at 1000.

³²⁰ The Second Circuit, in order to justify its jurisdiction over cases with the international element, used to apply these two tests distinct; In a recent case, the court combined them to show the strong relevance. See Nagy, Painter, & Sachs, *supra* note **Error! Bookmark not defined.**, at 99599; see also *SEC v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003).

³²¹ *SEC v. Traffic Monsoon, LLC*, 245 F. Supp. 3d 1275 (D. Utah 2017).

³²² *Id.*

securities transactions occurred.³²³ However, the Dodd-Frank Act's provisions are very important to insider trading enforcement because they allow the SEC and DOJ to prosecute cases no matter where the securities was listed or purchased.³²⁴

8. *The Detection and Surveillance Role of NYSE and NASDAQ*

The New York Stock Exchange, LLC (“NYSE”) and the National Association of Securities Dealers Automated Quotation, Inc. (“NASDAQ”) are the largest two equities-based and electronic screen-based stock exchanges in the world.³²⁵ As self-regulatory organizations, the NYSE and NASDAQ have their own regulatory systems with incredibly sophisticated algorithms and computer programs that flag and alert the SEC to out-of-the-ordinary trading.³²⁶ In turn, the SEC's sophisticated computer programs find recent news developments and then compile and examine lists of purchasers in order to determine if any of them have access to inside information and are involved in these securities transactions at all.³²⁷

³²³ Jonathan E. Richman, *Proskauer Rose Discusses the SEC's Extraterritorial Reach*, THE CLS BLUE SKY BLOG (April 11, 2017), <https://clsbluesky.law.columbia.edu/2017/04/11/proskauer-rose-discusses-the-secs-extraterritorial-reach/>.

³²⁴ 15 U.S.C. § 78u-6.

³²⁵ There are currently 13 registered stock exchanges operating in the United States. Section 3(a)(1) of the Exchange Act defines the term “exchange” as: any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

See Will Kenton, *What Is the New York Stock Exchange (NYSE)?*, INVESTOPEDIA (Mar. 23, 2020), <https://www.investopedia.com/terms/n/nyse.asp>.

³²⁶ NYSE Regulation, <https://www.nyse.com/regulation> (last visited Mar. 24, 2020); *Market Rules & Regulations Overview*, NASDAQ, <https://www.nasdaq.com/solutions/market-rules-regulations> (last visited Apr. 5, 2020).

³²⁷ More than 85% of Insider Trading violations are correlated to five different news categories: “Product announcements, Earnings announcements, Regulatory approval or denials, Mergers and acquisitions or Research reports, which they collectively refer to as PERM-R events.” A study in 2017 sought to identify mathematical patterns that capture the relationship between trading behaviors of insiders through collecting insider trade filings by the SEC through the EDGAR “with the aim of initiating an automated large-scale and data-driven approach to the problem of identifying illegal insider trading.” See Adarsh Kulkarni, Priya Mani & Carlotta Domeniconi, *Network-based Anomaly Detection for Insider Trading* (Feb. 19, 2017), <https://arxiv.org/pdf/1702.05809.pdf>.

9. The NYSE

The NYSE's regulatory system monitors securities activities and addresses non-compliance with its rules, as well as federal securities laws, in order to "promote just and equitable principles of trade, encourage free and open markets, and protect investors and the public interest."³²⁸ The NYSE's insider trading detection techniques apply computer algorithm-based programs to prediction and data synthesis, similar to the SEC's detection mechanism.³²⁹ However, there is a "middleman" on the NYSE trading floor that sits behind the traders in every securities transaction. We will examine the authorities and regulations that govern that person's activities in order to curtail insider trading.

The NYSE is an auction market, and the middleman who matches the best price for the purchaser with the best price for the seller is called the "Designated Market Maker" (DMM), formerly known as "the specialist."³³⁰ The DMM plays a crucial role in the stock trading process on the NYSE. Section 240.11(b)(1) of the Exchange Act refers to the DMM as a member who may "act as a dealer," or "act as broker."³³¹ The DMM's responsibilities are:³³² (1) To maintain their assigned securities markets fairly and orderly; (2) To act as dealer by matching the highest bid with the lowest offer of certain stocks they are assigned;³³³ (3) To engage in with their own account, using their own capital, and with an informed decision to reduce market volatility; and (4) To facilitate price discovery trading to treat market imbalances or instability in case there is no sufficient buyers or sellers.³³⁴ The DMM's failure "to engage in such a course of dealings will result in the suspension or cancellation of such specialist's registration in one or more of the securities in which such specialist is registered."³³⁵

9.1 Regulations Govern the DMM's Role in NYSE

The NYSE exercises its surveillance authority over the DMM at the end of the trading day and then modifies the DMM's prohibited Transactions

³²⁸ NYSE Regulation, *supra* note 326.

³²⁹ *Id.*

³³⁰ See Will Kenton, *Designated Market Maker (DMM)*, INVESTOPEDIA, <https://www.investopedia.com/terms/d/designated-market-maker-dmm.asp> (last updated Feb. 19, 2020).

³³¹ See Section 3(a)(4)(A) of the Exchange Act for broker-dealer's definitions.

³³² See Section 240.11b-1 of the Exchange Act; *see also* NYSE Rule 104 Governing Transactions by DMM.

³³³ Most specialists are responsible for trading five to ten stocks. See Fast Answers—Specialists, <https://www.sec.gov/fast-answers/answersspecialisthtm.html> (last visited Mar. 24, 2020).

³³⁴ See NYSE Rule 104(f)(ii).

³³⁵ See Section 240.11b-1-ii.

in three ways.³³⁶ First, because the rule already prohibits transactions that will create a new high or low price, the NYSE will also modify “Aggressing Transactions” that will result in a new consolidated price.³³⁷ Second, in determining prohibited transactions NYSE will not only consider the DMM’s position as defining feature in its decision regarding prohibited transactions. Third, shorten the period of announcing the DMM’s prohibited transactions to the market.

Further, the DMM could be the first tier of measures to prevent securities fraud. Hence, NYSE has a set of a very detailed regulations and rules governing the conduct and actions of the DMM to ensure that the securities are properly and fairly traded.³³⁸ Rule 2020 of the NYSE rules reads: “No member or member organization shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.”³³⁹ The NYSE Regulation (“NYSER”) of detection and surveillance oversees the trading activities on the NYSE markets and enforces compliance with securities regulations.³⁴⁰

Prior to January 2016, the NYSE outsourced its surveillance and enforcement of regulations to the Financial Industry Regulation Authority (“FINRA”) through contract.³⁴¹ After the contract period NYSE is to take the responsibility of surveillance, investigation, and enforcement of regulations in the NYSE markets while FINRA will continue performing surveillance on the cross-market transactions.³⁴² The DMM are obliged to electronically submit all of the information regarding its trading activities to the NYSE.³⁴³ This information will be gathered in the Intermarket Surveillance Information

³³⁶ See NYSE Rule 104(g)(i)(A)(III).

³³⁷ The SEC Release No. 34-84515, defined Aggressing Transaction by “the DMM transaction that is (1) a purchase (sale) that reaches across the market to trade as the contra-side to the Exchange published offer (bid); and (2) priced above (below) the last differently-priced trade on the Exchange and above (below) the last differently-priced published offer (bid) on the Exchange.”

³³⁸ See *Dealings and Settlements (Rules 45—299C)*, FINRA (2020), <https://www.finra.org/rules-guidance/rulebooks/retired-rules-9>.

³³⁹ See 2020. *Use of Manipulative Fraudulent Devices*, FINRA (2020), <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2020>.

³⁴⁰ NYSE Regulation, *supra* note 326.

³⁴¹ SECURITIES AND EXCHANGE COMMISSION (Release No. 34-83740; File No. SR-NYSE-2018-33) at 3, Securities and Exchange Commission (July 30, 2018)

³⁴² Memorandum from NYSE Regulation on NYSE Regulation January 1, 2016 Launch of Certain Surveillance, Investigations, and Enf’t Functions Currently Performed By FINRA to All NYSE, NYSE MKT, and NYSE ARCA Members and Member Orgs. (Nov. 23, 2015).

³⁴³ *Dealings and Settlements (Rules 45—299C)* *supra* note 338.

System (ISIS) of the NYSE.³⁴⁴ The ISIS information will be used to observe price movements and detect market unusual trading patterns. Computer formula techniques will examine insider trading through analyzing ISIS data and detect market activities that has the characteristics of a trading activity that violates the rules.

10. *The National Association of Securities Dealers Automated Quotation (“NASDAQ”)*³⁴⁵

NASDAQ is a market developed by the National Association of Securities Dealers (NASD) to be a stock market that services electronic securities trading internationally.³⁴⁶ “The Nasdaq Stock Market has three distinctive tiers: The Nasdaq Global Select Market, The Nasdaq Global Market and The Nasdaq Capital Market. Applicants must satisfy certain financial, liquidity and corporate governance requirements to be approved for listing on any of these market tiers.”³⁴⁷

The market structure of NASDAQ is different from that of the NYSE. The model of NASDAQ, as an electronic screen-based system, was initially created to serve as an option to the specialist-based system.³⁴⁸ NASDAQ is a dealer’s market where the sellers and the purchasers will not be participating in a direct trade but will be trading through a dealer. In the NYSE, the DMM are the market makers, while in NASDAQ the market makers are the dealers who will be on at least one side of every trade.³⁴⁹

10.1 *Regulations Govern the Dealer’s Role in NASDAQ*

The dealers that are the members of NASDAQ are subject, in strict compliance, to the rules and regulations of the SEC, FINRA, and NASDAQ itself.³⁵⁰ Those rules include the minimum capital, sales methods, trade

³⁴⁴ James L. Cochrane, Brian McNamara, James E. Shapiro, & Michael J. Simon, *The Structure and Regulation of the New York Stock Exchange*, 19 J. CORP. L. (1993).

³⁴⁵ NASDAQ Inc is an American international financial services corporation that owns and operates the NASDAQ stock market and eight European stock exchanges. See *Nasdaq Inc.*, WIKIPEDIA, <https://en.wikipedia.org/wiki/Nasdaq, Inc.> (last modified Mar. 28, 2020).

³⁴⁶ *Id.*

³⁴⁷ See Nasdaq Listing Center, *Initial Listing Guide*, (2018).

³⁴⁸ Will Kenton, *NASDAQ Global Select Market Composite*, INVESTOPEDIA, <https://www.investopedia.com/terms/n/nasdaq.asp> (last updated Mar. 2, 2020).

³⁴⁹ James L. Cochrane, Brian McNamara, James E. Shapiro, & Michael J. Simon, *supra* note 344.

³⁵⁰ See NASDAQ, INC., *FORM 10-K*, EDGARPRO (Feb. 28, 2018), <http://ir.nasdaq.com/static-files/a6d84f2a-c05a-484d-9d3b-06573888344f>.

practices, record of information, and protection of funds of the customers.³⁵¹ The rules and regulations imposed on NASDAQ's dealers also serve as a first-level measure against securities fraud.³⁵²

For the purpose of detection and surveillance, NASDAQ employed supplementary measures in addition to the rules and regulations imposed on its dealers. The Securities Exchange Act obliges issuers that trade their securities on NASDAQ to file an annual report and to provide NASDAQ with any information requested in case of any suspicious market activities.³⁵³ The filing process is done electronically through Electronic Data Gathering, Analysis, Retrieval "EDGAR."³⁵⁴ As we said in NYSE, NASDAQ also applied advanced technology techniques to detect insider trading violations. NASDAQ has adopted Artificial Intelligence to surveil insider trading and securities fraud.³⁵⁵ The software indicates the transaction that has unusual linkage of interests.³⁵⁶ The information of any suspicious trading activity will be passed to the SEC for investigation.³⁵⁷

Furthermore, NASDAQ recently introduced the SMARTS Trade Surveillance and SMARTS Market Surveillance systems for detecting various kinds of securities fraud or dark trading activities, including but not limited to price control and insider trading.³⁵⁸ The SMARTS Market Surveillance system is described as "the industry benchmark for the real-time" and T1 solutions for market surveillance, supervision, and compliance.³⁵⁹ The SMARTS Trade Surveillance system focuses specifically on the surveillance and monitor of trading activities rather than the market as a whole. It alerts the compliance teams of the seller in case of an appearance of any suspicious trading activities resulting from the detection, investigation, or system analysis.³⁶⁰

³⁵¹ *Id.*

³⁵² *Id.*

³⁵³ *Guide to Broker-Dealer Registration*, SEC (Apr. 2008), <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#foot1>.

³⁵⁴ *Id.*

³⁵⁵ *Supra* note 326.

³⁵⁶ Sara R. Hedberg, *IJCAI-03 Conference Highlights*, AI MAGAZINE, Dec. 15, 2003, at 9.

³⁵⁷ *Id.*

³⁵⁸ Roy Girasa, Jessica A. Magaldi, & Joseph DiBenedetto, *Shedding Light on Dark Pools: Recent Regulatory Attempts Toward Transparency and Oversight of Alternative Trading Systems*, 37 N.E. J. LEGAL STUD. 75 (2018).

³⁵⁹ *Nasdaq (SMARTS) Trade Surveillance*, NASDAQ, <https://business.nasdaq.com/market-tech/marketplaces/market-surveillance> (last visited Mar. 31, 2020).

³⁶⁰ *Id.*

C. Prosecution of Insider Trading in the Egyptian Legal System

The Public Prosecutor's Office is the main Egyptian authority empowered to initiate all kinds of criminal charges. To reach the end of justice, the law, in some circumstances, limits the Public Prosecutor's Office prosecuting authority and makes it contingent on another entity's request. Egyptian's Capital Market Law (CML) makes the Public Prosecutor's Office authority to charge for securities violations contingent on a written permission from the chairman of the Financial Regularity Authority.

1. Financial Regularity Authority and the Public Prosecutor's Office

Prosecutions:

In order to unify the supervisory authority over the entire Egyptian non-banking financial markets, Article 3 of Law no.10 of 2009 replaced the Capital Market Authority by the Financial Regularity Authority (FRA).³⁶¹ The legislator wanted FRA to be the public authority in charge to enforce the provisions of CML 95 of 1992 over the entire Egyptian Stock Market. The FRA is an independent surveillance authority over the Egyptian stock market. Article 93 of the Executive Regulations of CML states that "the Authority (FSA) shall oversee the trading market and shall ensure compliance with the law and the executive regulations with respect to prohibited activities, such as fictitious transactions, price rigging, deceptive devices, cheating, manipulation and fraudulent activities in connection with securities transactions." Hence, the FRA is the main governmental authority in charge of achieving the stability and integrity of all of the non-banking financial markets. Additionally, the FRA in the Egyptian legal system is responsible for spreading investment culture and also licenses non-banking financial activities.

This means that the FRA not only exercises its surveillance authority over listed companies. Its authority extends, according to Egyptian companies' law no. 159 of 1981 to Joint Stock Companies, Limited Partnerships by Shares, and Limited Liability Partnerships.

³⁶¹ We may also refer to FRA by Egyptian Financial Supervision Authority (EFSA). See FIN. REG. AUTHORITY, http://www.fra.gov.eg/content/efsa_en/efsa_pages_en/efsa_clarification_en.htm (last visited Mar. 31, 2020).

1.1 FRA Enforcement Resources

The Egyptian FRA executes its obligations through the following sectors and offices:³⁶²

1. Sector of Financial Securities, Financial Statements and Corporate Finance;
2. Sector of Surveillance and Corporate Governance;
3. Sector of New Business Registration and Licensing;
4. Sector of Information Services;
5. Sector of Financial, Administrative Affairs and Personnel;
6. Central Department for Chairman's Office Affairs;
7. Central Department for Legal Affairs;
8. Central Department for Enforcement;
9. Central Department for Researches and Policies;
10. Central Department for Capital Market Development and its Securities;
11. Central Department for Investors Complaints;
12. Central Department for customer Services;
13. Central Department for Governmental Insurance Fund.

³⁶² *Senior Management*, FIN. REG. AUTHORITY, http://www.fra.gov.eg/content/efsa_en/efsa_pages_en/dir1_en.htm (last visited Dec. 7, 2018).

The Egyptian FRA issued its own code of ethics for its personnel to prohibit any action that might undermine public trust and the integrity of the Authority. These rules are:³⁶³

(1) **Fundamental ethics:** The staff shall observe the integrity and good conduct needed to gain public trust, fairness, and non-discrimination in their interaction with the public, execute job tasks with due diligence, cooperate with other FRA staff, be transparent without violating protected information, and observe a high level of decorum with any person interacting with the Authority.³⁶⁴

(2) **Exchange of data and private information:** Staff shall maintain capital market information privacy and not share it outside the Authority; staff shall take all necessary precautions to keep all private information secret; it is prohibited for the FRA staff, except those who are authorized, to make a press release (especially information related to stock prices and corporations listed on the stock market as well as any corporate information discovered as a result of FRA surveillance procedures); it is prohibited for FRA staff members or their relatives to receive any benefits in exploiting nonpublic information that is possessed as a result of being in an FRA personnel role.³⁶⁵

(3) **Trade on Stock Market:** FRA staff are not allowed to trade personally, or through any other person, on listed corporation stocks except in IPOs, public mutual funds, governmental pounds, or unlisted securities. If any member of the FRA owns or inherited stocks in Egyptian Exchange (EXG) when this decree comes into force, that member shall not sell it before putting the FRA on notice.³⁶⁶

(4) **Gifts and Courtesy Policy:** FRA staff are prohibited from accepting any gifts from any entity subject to FRA surveillance authority except when the gift is nominal; gifts do not have to be pecuniary but could be a discount for a service received or a free vacation for the staff member or the staff member's relatives.³⁶⁷

1.2 FRA Detection Mechanism

There are three main systems of detection adopted by the FRA:

³⁶³ See the decree of the FRA Chairman no. 75 on June 7, 2010; *see also EFSA Staff Code of Ethics*, Egyptian Financial Supervisory Authority (EFSA) (Apr. 2010),

http://www.fra.gov.eg/content/efsa_en/pool_extra_efsa_en/methaq1_efsa_en.htm.

³⁶⁴ *Id.* at 7.

³⁶⁵ *Id.* at 8.

³⁶⁶ *Id.* at 9.

³⁶⁷ *Id.* at 11.

- (1) **Observation of stock market bids:** The FRA Central Department of Enforcement has a unit connected with the Egyptian Stock Exchange trading screens. The units observe the transactions and take notes for bids and deals closed by broker-dealer's firms and then track its future impact on stock prices. If there was any suspicious activity committed, the unit will open an investigation to address any possible enforcement action.
- (2) **Corporation's file examination:** This particular manner of surveillance is executed by examining a corporation's file and its periodical financial and administrative reports presented to the FRA.
- (3) **Corporation field visit:** The CML grants the FRA staff the powers and authority of law enforcement officers. FRA staff may or may not notify corporations about FRA's pending field visits where they may examine the corporation's books and ask for the production of any specific documents or question any of the corporation's personnel in order to ensure the correct observation of the regulations.

1.3 FRA Prosecuting Authority

The Egyptian FRA resembles the American SEC in its role of oversight and ensuring compliance with the law of the stock market. The CML in article 69 (bis) states: "It shall not be allowed to prosecute for crimes of CML except by virtue of a written request from the chairman of the Financial Regularity Authority."³⁶⁸ Thus, the law gives the FRA's chairman—solely—the authority to initiate criminal charges of insider trading or any securities fraud committed in violation of the CML and its executive regulations. Criminal charges under the CML are brought about by a report signed by the chairman of the FRA that includes an explanation of violations and asks the Public Prosecutor's Office to initiate such charges. This report is an administrative report, not a judicial order, which means it does not initiate the criminal prosecution and is not subject to judicial review.³⁶⁹ The report gives the Public Prosecutor's Office the authority to initiate criminal charges. The FRA report does not oblige the Office to prosecute, as the Office has the discretion to investigate and ultimately proceed with the charges.

On the other hand, if the Public Prosecutor's Office knows about the CML violation from any source and desires to initiate criminal charges against the violators, the Public Prosecutor's Office is required to obtain the FRA chairman's permission to proceed with the investigations. The CML also provides the chairman of the FRA with the authority to cancel or to dismiss

³⁶⁸ Article 69 (bis) added by law no. 123 for 2008; *see also* article 6 of law no. 10 for 2009, bar Public Prosecutor's Office from initiating a criminal investigation without a written consent from FRA.

³⁶⁹ Nisreen F. Ibrahim, *Alreqaba Aledareyaha Wal qdaieyaha Ala A'mal Aledaraha fe Magal Souq AlAwraq Al malyiah [The administrative and judicial surveillance over the public administrative authority role on stock market]* (2016).

charges despite the state of progress in investigations or court judgment execution.³⁷⁰

Article 49 of the CML grants the FRA officers the power and authority of law enforcement officers. This authorizes FRA officers to access registers, books, documents and any information in the company's offices, in the stock exchange, or other offices where these documents may exist. It also obliges such entities to cooperate and to produce a copy of any documents that may be requested by officers. This article reflects the intent of the Egyptian legislature to curtail securities market violations and to reach a reasonable level of efficiency. It suggests that the FRA obligations are not merely to issue licenses and permit securities offerings, but to take positive steps to reduce market violations.

1.4 FRA Administrative Sanctions:

Besides its prosecuting authority, the FRA has the power to apply administrative sanctions for corporate violations. According to article 31 of the CML, these sanctions could include a notice asking the company to cancel or stop the violations within a specific timeframe, limitation of the company's scope of business,³⁷¹ or appointment of an independent member on the company's board of directors. The appointed member will oversee and participate in the board decisions. Also, FRA sanctions could amount to dissolution of the board and appointment of an authorized agent until a new board of directors is appointed. Similarly, such sanctions could compel the company to increase its security deposit in order to protect investors.

2. Egyptian Stock Exchange

The Egyptian market used to have two stock exchanges: the Alexandria Stock Exchange and the Cairo Stock Exchange. Law no. 123 for 2008 merged them together into one stock exchange called the Egyptian Stock Exchange (EXG). Under Rule 902(b) of the Securities Act of 1933, the Egyptian Exchange (EGX) is an offshore securities market.³⁷² The EXG is a governmental public entity, but the CML allows the establishment of private

³⁷⁰ The policy objectives behind authorizing the FRA chairman to enter into settlement or reconciliation agreement with the convicted of securities fraud is to trump the economic benefits over the incarceration punishment when the convicted accept to pay the double of the statutory fine. We do not agree with this policy because deterrence could not be achieved, especially when the defendant is a corporation or a wealthy businessman.

³⁷¹ See FRA Chairman decree no. 885 for 2018 (freezing trading activities of Grand Investment company for a month); see also FRA Cdecree no. 888 for 2018 (freezing the activities of TIBA for Securities Brokerage for a month).

³⁷² Letter from Paul M. Dudek, Chief, Office of Int'l Corp. Fin., to Sameh El Torgoman, Chairman, Cairo and Alexandria Stock Exchs. (Apr. 6, 2003) (on file in the SEC online archives).

corporations to exercise stock exchange business.³⁷³ The EXG executes its responsibilities through a board of nine members headed by the EXG chairman, and it includes a member from the Egyptian Central Bank. Three members represent capital market companies, and two members representing listed companies.³⁷⁴ EXG decrees are administrative orders amenable to judicial review.³⁷⁵ The EXG board of directors regulates the stock market trading rules and oversees its efficiency. The EGX is the primary and secondary equity market and exchange for both stocks and bonds.³⁷⁶ The EGX consists of the official market, which includes publicly listed companies, and the unofficial market, where the transfer of unlisted securities takes place. The unofficial market transactions are still subject to revision and approval of the EGX.³⁷⁷

Article 21 of CML states: The chairman of EXG may suspend trading bids aiming at price manipulation, and he may revoke transactions which violate securities market regulations. He may also suspend the trading of a given security in case it causes harm to the market or may revoke transactions that are executed in violation of the CML securities provision.

3. *Private Right of Action Under Egyptian Law*

Egyptian law allows bringing a case for civil remedies incurred as a result of violations of the securities law. The executive regulation of the CML in article 218 expressly allows shareholders to bring private actions when they suffer financial loss because of insider trading. The law does not require the proof of actual reliance on a defendant's misstatement or the existence of a fiduciary relationship; it only requires the showing of causation that one actually suffered losses because of the insider transaction or being a victim of securities market manipulation.

4. *Insider Trading Jurisdiction*

Since insider trading under Egyptian law is a crime, the jurisdiction to adjudicate the violation of insider trading is a non-administrative court (Economic Courts).³⁷⁸ The reason behind establishing Economic Courts as

³⁷³ Law No. 95 of 1992 (Law of Capital Market), *supra* note **Error!**

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³⁷⁴ See article 6 of the presidential decree no. 191 for 2009.

³⁷⁵ Ibrahim, *supra* note 369.

³⁷⁶ Omar S. Bassiouny & Ahmed Abdelgawad, *Equity Capital Markets in Egypt: Regulatory Overview* (2016).

³⁷⁷ *Id.*

³⁷⁸ For more details about the Egyptian judicial system, see Mohamed Abdel Wahab, *Update: An Overview of the Egyptian Legal System and Legal Research*, GLOBALLEX (2008), <https://www.nyulawglobal.org/globalex/Egypt1.html> (“[T]he Egyptian Judiciary is comprised of secular and religious courts, administrative and non-administrative courts, a Supreme Constitutional Court, penal

specialized courts in the Egyptian judiciary system is to fulfill the requirements of the corporate sector by expediting the dispute resolution period and to guarantee that commercial and economic cases are heard by a well-informed panel.

The law of the Egyptian Economic Courts (EEC) no. 120 for 2008 in article 4 granted the courts of first instance and courts of appeals of the EEC—solely—the jurisdiction to hear criminal cases of the CML. Further, the EEC in article 6 granted the courts of first instance of EEC jurisdiction to litigate CML monetary disputes on cases over five Egyptian million.³⁷⁹

CONCLUSION

Insider Trading in the Egyptian Law Needs a Drafting Reform:

As per the insider trading provisions of CML and its executive regulation, the Egyptian legislature has a clear intent to prohibit insider trading. The Egyptian legislature expressly criminalized insider trading in the CML and its executive regulation as well as in article 345 of the Egyptian Criminal Code, which regulates securities anti-fraud provisions that are applicable to insider trading offenses. However, the law of insider trading is sometimes misplaced, or its drafting style fails to properly address the offense of insider trading. This can be clarified as follows:

(1) The language of Article 64 of the CML does not clearly encompass all insider trading presumed violations. Insider trading laws need to be drafted using generic terms applicable not only to officials of FRA or any market player whose actions are governed by securities law, but also to any person who trades stocks on the basis of material nonpublic information. Furthermore, even though Article No. 20 (*bis*) of the CML prohibits tipping of inside information by using the term “any person,” its drafting style improperly inserted the definition of information materiality in addition to including causation terms into the text, which might bar charging for insider trading if there are no direct and immediate losses incurred as a result of insider trading.

(2) The executive regulation of the CML in Article 319 not only interprets the legislation of the CML, but it also exceeds the scope of interpretation to criminalize insider trading. Since the law of insider trading in the CML is not self-sufficient as a basis to prosecute for the offense of insider trading, the executive regulation of the CML provisions will be required in order to prove

courts, civil and commercial courts, personal status and family courts, national security courts, labour courts, military courts, as well as other specialized courts or circuits.”).

³⁷⁹ However, if the defendant in a CML basis dispute is a public administrative authority or the plaintiff pray to revoke or amend a public authority decree the jurisdiction will be concluded to the State Council Administrative Courts.

a well-grounded insider trading case. However, this is not constitutional because the executive regulation is issued as per a ministerial decree.

(3) The executive regulation of the CML regulated an uncomprehensive separate prohibition of insider trading that is only applicable to portfolio management and brokerage companies. Article 244 of section five of chapter six of the executive regulation prohibits owners, directors, and employees of a portfolio management company or brokerage company from *transacting* on any securities on the basis of nonpublic information. The phrasing of Article 244 is redundant because, if the CML law of insider trading is a general and abstract law, there is no need to reregulate insider trading for portfolio management and brokerage companies. Yet, Article 244 insider trading law does not encompass all conceivable insider trading violations of owners, directors, and employees of a portfolio management company or brokerage companies.

The Need for an Effective Enforcement Mechanism and Adequate Resources

Langevoort once said, “One of the most obviously, and troubling, phenomena in international securities regulation is that even as the ‘law on the books’ in most developed countries . . . the commitment of surveillance and enforcement resources varies considerably.”³⁸⁰ Egyptian law ostensibly aims at prohibiting securities fraud. The Egyptian judiciary system does not tolerate securities fraud and firmly applies securities law. However, there is no effective enforcement mechanism in place. On the other hand, although the United States insider trading law in some circumstances does not achieve clarity and completeness, the SEC applies a very effective enforcement mechanism.

The Need for More Resources

In order for the Egyptian FRA and the Egyptian Stock Exchange to undertake their surveillance role over the securities market, they need to adopt the same theory of detection and enforcement mechanisms employed in highly active stock markets. As we explained in Chapter II, the fraud detection mechanism adopted by the SEC relies on smart technology and computer programs.

³⁸⁰ Donald C. Langevoort, *Cross-Border Insider Trading*, 19 DICK. J. INT'L L. 161, 163 (2000).

The FRA responsibilities over the entire non-banking sector are crucial. In order to undertake these responsibilities, it requires adequate resources to better guide the Egyptian economic reform.³⁸¹

³⁸¹ In addition to the insider trading law reform and while the Egyptian authorities relentlessly strive to boost the Egyptian economy, the stock market's refinement should be their top priority. As such, the main role expected from the Egyptian FRA and EGX at the moment is to ease the capital formation to push the wheels of such heavy industry. The Egyptian legislature has been pleading with corporations working in Egypt to list their securities in the EGX and has attempted to incentivize corporations to do so through a considerable tax deduction scheme. Yet, there is a meager number of listed corporations in the EGX. Time is running out; it is naïve to wait for family-based corporations to build the Egyptian economy. For Egyptian national policy to influence real investment, the legislature should concentrate on assisting the private sector and startup businesses in particular. Capital formation in Egypt's economic system is still very costly because of the exorbitant interest rate in the entire economic system, and this could undermine the practicability of capital formation. The Egyptian economic system is in a dire need of the investment of middle-class citizenry in corporations' stocks. Consequently, they had to introduce and renew public trust in the stock market. This could be the only solution to both overcome the challenge of high interest rates and ease the capital formation of new businesses. Tax deduction incentives should be given primarily to corporations that devote a percentage of their revenues to research funding. The Egyptian legislature should enact a law that considers such research funding to be a social responsibility of corporations operating in Egypt. We believe that only one important Egyptian patent can push the economic growth forward to make great strides.

